

## DEAR BARON SMALL CAP FUND SHAREHOLDER:

## PERFORMANCE

Baron Small Cap Fund gained 12.30% in the fourth quarter. The Fund was down 1.58% for the 2011 year.

**Table I.**  
Performance (Retail Shares)<sup>†</sup>  
Annualized for periods ended December 31, 2011

	Baron Small Cap Fund <sup>1,2</sup>	Russell 2000 Growth Index <sup>1</sup>	S&P 500 Index <sup>1</sup>
Three Months <sup>3</sup>	12.30%	14.99%	11.82%
One Year	-1.58%	-2.91%	2.11%
Three Years	18.01%	19.00%	14.11%
Five Years	1.87%	2.09%	-0.25%
Ten Years	7.37%	4.48%	2.92%
Since Inception (September 30, 1997)	8.45%	2.65%	3.84%

Our performance was less than the Russell 2000 Growth Index in the quarter (which was up 14.99%), but outperformed for the year (Russell 2000 Growth Index was down 2.91%). The Fund outperformed the S&P 500 Index in the fourth quarter, but trailed for the year.

Stocks rebounded in the fourth quarter after a sharp correction in the third quarter. Macro issues continued to dominate investor attention, primarily concerning the Eurozone crisis, and the markets remained highly volatile, bouncing around from one headline to the next. The primary reason for the rebound was that a number of economic indicators provided reassurance that a recession was not imminent, as was feared in the fall. In fact, economic growth in the fourth quarter is expected to be the strongest of the year, projected to come in around 3% as compared to 1.2% for the first three quarters. The unemployment rate fell too, and there are signs that the housing market is bottoming.

Performance listed in the above table is net of annual operating expenses. Annual expense ratio for the Retail Shares as of September 30, 2011 was 1.31%. *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 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](http://www.BaronFunds.com) or call 1-800-99BARON.*

<sup>†</sup> 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.

<sup>1</sup> The Russell 2000 Growth Index and the S&P 500 Index are unmanaged. The Russell 2000 Growth Index measures the performance of 2,000 small U.S. companies classified as growth. The S&P 500 Index measures the performance of large cap U.S. equities in the stock market in general. These indexes and the Baron Small Cap Fund are with dividends, which positively impact the performance results.

<sup>2</sup> 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.

<sup>3</sup> Not annualized.



CLIFF GREENBERG  
PORTFOLIO MANAGER

Small stocks outperformed large stocks in the quarter as the economic outlook started to firm up and economically sensitive sectors (Energy, Information Technology, Industrials) did the best. Stocks continued to trade in a highly correlated fashion. This has been the case since August when fundamentals have taken a back seat to macros.

2011 was a year of two very different halves. We would characterize the first half of 2011 as a "stock-pickers" market and the back half as anything but. The Fund had a strong first half in both absolute and relative performance, and we gave back all the profits and some of our relative outperformance in the back half.

**Table II.**  
Top contributors to performance for the quarter ended December 31, 2011

	Percent Impact
SBA Communications Corp.	0.66%
Brigham Exploration Co.	0.65
TransDigm Group, Inc.	0.52
Penn National Gaming, Inc.	0.50
Clean Harbors, Inc.	0.49

Most of the portfolio acted well in the quarter along with the market for small cap stocks. Our Energy, Information Technology, and Industrials sectors were the leaders and provided the majority of the return.

Shares of cellular tower provider **SBA Communications Corp.** were strong in the quarter. Fundamentals remained solid and we think the outlook is bright for higher sustainable growth driven by increasing sales of smartphones and the resultant expanding demand for mobile broadband data services that the devices enable. The potential negative of carrier (customer) consolidation went away with the collapse of the AT&T/T-Mobile merger. And **American Tower Corp.**, the industry bellwether, a Fund holding, traded higher on its conversion to a REIT. We believe this has resulted in higher valuation for its comparables.

# Baron Small Cap Fund

**Brigham Exploration Co.**, an oil exploration company, was acquired by Statoil, the Norwegian national oil company, at a 35% premium. We are satisfied with the price and note that this is the second of our oil holdings to be acquired in what is a significant industry consolidation. We maintain positions in other similarly situated Energy & Petroleum companies and in some service businesses that cater to the new non-conventional energy plays.

Shares of **TransDigm Group, Inc.**, the manufacturer of airplane parts primarily for the aftermarket, were strong in the quarter and also the year. TransDigm grew its sales double digits organically and the business as a whole grew about 50%, including the results of an important acquisition. We remain impressed with the management team and the characteristics of the business (consistent organic growth/50% cash flow margins), and we believe the company will continue to make additional accretive acquisitions or return excess capital to shareholders, both of which have served us well in the past.

Some other holdings that had strong absolute performance in the quarter (up over 35%) included **Mistras Group, Inc.**, **The Ultimate Software Group, Inc.**, **Brookdale Senior Living, Inc.** and **The Chefs' Warehouse, Inc.**

**Table III.**  
Top detractors from performance for the quarter ended December 31, 2011

	Percent Impact
Polypore International, Inc.	-0.49%
Crocs, Inc.	-0.46
Shutterfly, Inc.	-0.41
National CineMedia, Inc.	-0.14
Masimo Corp.	-0.11

Most of the portfolio was ahead in the quarter. However, we did have a few clunkers, which were the primary reasons we underperformed the Russell 2000 Growth Index this quarter.

The bull case for **Polypore International, Inc.**, a leading high tech filtration company, is based on a stable and growing, annuity-like base business, in addition to, in our view, a significant opportunity to grow its sales of separators to Lithium-ion batteries used in electric vehicles. The market got spooked by a high-profile fire in the battery of a General Motors Volt test vehicle, but to think this will slow the upcoming rollout of hybrid and electric cars is foolish and short-sighted, in our opinion. We recently have added to our position and believe it's a great long-term growth story.

**Crocs, Inc.**, the maker of casual shoes, declined significantly in the quarter when the company reduced guidance for the back half of the year. The company encountered slowing sales in Europe and had some execution issues in its retail operations and with its new fall product line. We like new management and believe in its plan to diversify its product line and optimize its global distribution. We think Crocs can become a global lifestyle brand and has a real chance at much higher sales, margins and a stronger trading multiple.

**Shutterfly, Inc.**, a recent purchase as a "fallen angel," proved not to have fallen enough at the time of purchase and not to be such an angel. Severe price competition is affecting its near-term earnings and has had us re-think the company's market position and barriers to entry. We sold most of our position at a loss.

## PORTFOLIO STRUCTURE

As of December 31, 2011, Baron Small Cap had \$3.7 billion under management. The Fund is comprised of 95 stocks. The top 10 holdings comprise 25.3% of the Fund's assets. The turnover of the portfolio, measured over a three year period, was 30%.

**Table IV.**  
Top 10 holdings as of December 31, 2011

	Year Acquired	Quarter End Investment Value (millions)	Percent of Net Assets
TransDigm Group, Inc.	2006	\$129.2	3.5%
SBA Communications Corp.	2004	118.1	3.2
Penn National Gaming, Inc.	2005	118.0	3.2
Liberty Media Corp.	2009	97.6	2.6
Equinix, Inc.	2008	88.7	2.4
Clean Harbors, Inc.	2007	85.3	2.3
Waste Connections, Inc.	2009	82.9	2.2
Gartner, Inc.	2007	78.2	2.1
Fossil, Inc.	2005	71.4	1.9
Intuitive Surgical, Inc.	2003	69.5	1.9

The median market cap of the Fund was \$1.7 billion at the end of the quarter. This is down considerably from a year ago, as we continue to add new small stocks to the portfolio and sell or trim some positions with larger market caps. In the quarter, we invested in companies with a median market cap of \$1.7 billion and sold out of stocks with a market cap of \$3.2 billion.

For the year, we spent \$1.1 billion to add new ideas (\$800 million) and increase existing positions (\$300 million). This equates to about 30% of average capital under management, which is in line with our usual level of annual activity.

Consumer Discretionary stocks made up 22.2% of the portfolio in the quarter. Though this is higher than the Russell 2000 Growth Index, the weighting is down by over half from peak levels of 50% in 1999, and is the lowest ever in the 15 year life of the Fund. This is because we see less opportunity in consumer sectors in the current environment (high unemployment, consumer deleveraging) as we have been saying for a while. Much effort has gone into improving our research effort in other sectors and it is paying off. We have invested more in growth niches of the Energy, Industrials and Information Technology sectors. Information Technology was 18.2% of the Fund at year end and Energy was 8.4%, both high for the Fund.

## RECENT ACTIVITY

Table V.

Top net purchases for the quarter ended December 31, 2011

	Year Acquired	Quarter End Market Cap (billions)	Amount (millions)
FEI Company	2011	\$1.5	\$31.2
Acacia Research Corp.	2011	1.6	17.8
LaSalle Hotel Properties	2011	2.0	16.3
Superior Energy Services, Inc.	2011	2.3	16.2
Insulet Corp.	2011	0.9	14.6
Mattress Firm Holding Corp.	2011	0.8	13.9
Questcor Pharmaceuticals, Inc.	2011	2.6	13.8
Acuity Brands, Inc.	2011	2.2	11.9
Crocs, Inc.	2011	1.3	10.7
Tennant Co.	2011	0.7	8.5

We were not super active buyers in the quarter. The market's rise and the slowdown in the IPO calendar were the primary reasons.

**FEI Company** is a leading supplier of high-end electron microscopes, selling its product to materials research, healthcare and electronics end-markets. With the industry's leading technology and brand, we believe that the company has significant growth ahead in each of its channels. We are particularly intrigued with its new products for the oil and minerals exploration industries, which provide a wild card to our projections. The company has a very overcapitalized balance sheet, and, when we purchased the stock, cash on hand equaled about 30% of the company's enterprise value. We underwrote the trading multiple to be a modest 15 times growing earnings ex the cash and derive a price target of twice our purchase price in a couple of years.

**Acacia Research Corp.** has emerged as a leader in acquiring, licensing and enforcing technology patents. We have followed the company's development for some time but just this quarter purchased the stock when it fell out of favor. Acacia started as an incentive-based, outsource provider of monetization services to individual investors and small companies seeking to enforce claims against larger, better funded corporations. Acacia would receive half of the profits they would generate and it has built a nice business around this premise. Now, large companies have tired of being sued by Acacia and are beginning to view Acacia as a strategic partner as opposed to an agitator (a "patent troll" in industry parlance). They now view the company as a strategic partner in their own IP management efforts, and as a potential partner in buying IP portfolios outright. We believe this is a welcome development that will lead to greater profits and a higher multiple.

We also bought shares of upscale hotel REIT **La Salle Hotel Properties** and swapped out of another similar holding, with the belief we were buying into a better portfolio at a cheaper valuation. We continue to like the space since business is strong and, in our view, stocks don't reflect this. We also started positions in two growth healthcare companies, as Healthcare stocks fell out of favor with the market's shift back to economically sensitive sectors. **Insulet Corp.** makes an innovative, easy-to-use insulin pump. **Questcor Pharmaceuticals, Inc.**, is a specialty pharmaceutical company that is growing rapidly as it expands sales of its drug (Actar) to new indications.

Table VI.

Top net sales for the quarter ended December 31, 2011

	Year Acquired	Market Cap When Acquired (billions)	Quarter End Market Cap or Market Cap When Sold (billions)	Amount Sold (millions)
Brigham Exploration Co.	2009	\$0.9	\$4.2	\$-73.0
Ecolab, Inc. (formerly, Nalco Holding Co.)	2006	2.4	5.4	-33.4
Nordson Corp.	2009	1.9	2.7	-25.1
Texas Roadhouse, Inc.	2004	0.6	1.0	-20.4
Tetra Tech, Inc.	2009	1.6	1.4	-15.4
Pebblebrook Hotel Trust	2009	0.4	0.9	-11.8
Trex Company Inc.	2011	0.4	0.3	-10.9
PAA Natural Gas Storage, L.P.	2011	2.1	1.5	-10.1
Kraton Performance Polymers, Inc.	2010	0.8	0.7	-10.0
Eagle Materials, Inc.	2004	0.2	0.9	-9.5

In the quarter, we liquidated our position in **Nalco Holding Co.** and **Brigham Exploration Co.**, which were acquired. We sold out of our longtime holdings in **Texas Roadhouse, Inc.** and **Eagle Materials, Inc.**, as they met near-term price objectives and we determined that we had better ideas for the capital. We also trimmed some of our industrial company, **Nordson Corp.**, because its stock was up and it has big exposure to Europe.

## OUTLOOK

As we start the new year, the market is presently on an upswing, as concerns about the Euro Crisis have lost dominance. In late December, the European Central Bank (ECB) took a bold, "Fed-like" step to provide very low interest loans to European banks to help address a potential credit crunch. Interest rates of sovereign debt have declined materially. Though the issues in Europe are not solved, they are less pressing for now. We are not out of the woods, but the market has calmed down, volatility is quiet and investors seem to be saying "enough" with all this focus on Europe.

Investors are taking notice that the U.S. economy is improving and has been gaining momentum since October. We are no longer concerned about recession. However, we are being tempered and are reluctant to underwrite strong growth for the upcoming year. European economies are in recession, which might be severe. Emerging market economies have slowed. The U.S. is still in deleveraging mode, meaning government spending must be constrained to reduce debts and unemployment remains stubbornly high. Positive offsets, which could lead to continued strong economic growth, might be improving stock markets or a real bottoming in home values, both of which, if they occurred, could lead to a pickup in consumer and business confidence and in spending/investments.

Even in an environment of modest growth, we believe our holdings can increase their earnings at a nice pace, even if somewhat slower than last year. We think this is not reflected in stock prices. We believe that stocks trade at cheap multiples because the market was flat last year, even as earnings grew and in light of our expectations of more growth this year. Investors are shaken by volatility and show no patience or desire to look long term, which is the

# Baron Small Cap Fund

opposite of our mind set. Still, we do remain concerned that the eventual solution to the Euro Crisis could have negative global ramifications beyond just recession in Europe, and we are watching developments with a wary eye.

Concerning positioning of the portfolio, we have not made significant changes in its structure. We remain offensive. We favor growth companies, though they will be harder to find in this "muddle through" economy. We believe over the long term these will be appreciated more and will be valued more dearly. As opposed to hiding out in defensive sectors or seeking yield, we have maintained our large concentrations in economically sensitive sectors because we believe the secular stories of our holdings will enable continued growth irrespective of the economic backdrop.

We are hoping for a return of dispersion in stock prices, as was the case in the first half of last year. So far, we are seeing a renewed focus on fundamentals and stock prices tracking results, which is welcome. However, fourth quarter earnings might be sloppy because the economy hit some air pockets late last year. Projections for 2012 will probably be conservative and negatively affected by currency translations reducing the earnings of some of our holdings, which are growing their profits abroad.

We expect more IPOs, which is a good thing since it gives us more merchandise to consider. We at Baron have a great process to focus on new offerings, and I would expect to find a handful of new ideas this year. Also, I believe that mergers and acquisitions will be more prevalent for small caps. Our holdings are often pursued by bigger companies looking for growth and newness. And our companies often make acquisitions that are meaningful to their future growth. In those cases, we win either way.

**Thank you for your continued interest in the Fund.**



Cliff Greenberg  
Portfolio Manager  
January 18, 2012

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



---

*The Adviser believes that there is more potential for capital appreciation in smaller companies, but there also may be more risk. Specific risks associated with investing in smaller companies include that the securities may be thinly traded and they may be more difficult to sell during market downturns. The Fund may not achieve its objectives. Portfolio holdings are subject to change. Current and future portfolio holdings are subject to risk.*

The discussions of the companies herein are not intended as advice to any person regarding the advisability of investing in any particular security. The views expressed in this report reflect those of the respective portfolio manager only through the end of the period stated in this report. The portfolio manager's views are not intended as recommendations or investment advice to any person reading this report and are subject to change at any time based on market and other conditions and Baron has no obligation to update them.

This report does not constitute an offer to sell or a solicitation of any offer to buy securities of Baron Small Cap Fund by anyone in any jurisdiction where it would be unlawful under the laws of that jurisdiction to make such offer or solicitation.