

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 Energy and Resources Fund

# Baron Funds®

## Quarterly Report

June 30, 2013

*"We knew their grandparents well!" Ivor Braka. Real estate and banking entrepreneur. 2013.*

A few months ago, Ivor Braka called me to ask if he could visit my office. Ivor is the older brother of a high school friend I haven't seen or heard from for many years. Ivor's family for many generations had been unusually successful in a variety of businesses. As a result, his family has become among the most prominent in the small, middle class, Jersey Shore, beach town where I grew up. Although I could not recall having spoken to Ivor since 1961, when I graduated from Asbury Park High School, I invited him to lunch.

When Ivor visited, we spoke principally about his family's business interests. Under his entrepreneurial leadership, the value of his family's assets had grown materially. The assets for which he is now responsible comprise interests in real estate in New York and other gateway cities around the world; international banking; and, most recently, shipping. I asked him about his staff of advisors and how he achieved the expertise I believed was necessary to invest in such a diversified group of businesses. "Like you, I invest in people," he began. "I invest with people in whose skills I am confident and whom I know well. In most cases, we also knew their grandparents well. If I am uncomfortable with a potential partner's grandparents' ethics,



integrity and character, we don't invest," this successful entrepreneur told me.

Ivor's family is a close knit one. Many of his forebears had been associated with the forebears of the families of his present business partners for more than 500 years!!! This is because around 1492, during the Spanish Inquisition, the Sephardic Jewish ancestors of these individuals were forced to flee their homes in Spain. If they had not left their homeland and had attempted instead to continue to live in Spain without converting to Christianity, they would have been tortured or killed!

After leaving Spain, many of this clannish community remained closely associated with each other for the following five centuries! While we pride ourselves in knowing managements well, we clearly can't compare our associations to Ivor's 500 year relationships. But, we nevertheless do share with him the same ideas about investments in people and "trust."

*"We invest in people, not just buildings"... just like Ivor.*

A friend who provides venture financing to startup businesses recently told me that "no business plan we have reviewed has ever worked as it was supposed to." Advisers to my friend had recommended numerous times that several businesses, each now worth billions, should be closed... while they were still "early stage" before they became successful. This was because the problems those businesses faced seemed insurmountable.



## Letter from Ron

It's all about the people who found a way to overcome those obstacles and made those businesses successful against the odds, he thinks.

In the world of publicly-owned businesses, we try to invest with the same sort of individuals. In our opinion, Michael O'Leary, Ryanair's Chairman and CEO, is one such example of a talented, driven executive. Michael was born on a farm in Ireland, the second oldest of six siblings. Although his beginnings were not remarkable, Michael figured out how to get the best education he could by attending the best schools he could. After attending a Jesuit boarding school as a young boy, he graduated from Trinity College with an accounting degree; began his career working for KPMG, a large public accounting firm; and, soon afterwards, became a financial advisor to Tony Ryan, Ryanair's founder. In 1986, Michael was hired to work for Ryan and initially advised him to close the airline immediately since it was losing so much money! In 1989, when Ryanair was on the brink of insolvency, Ryan offered Michael the job of Deputy CEO of the airline and in 1994 as its CEO. Michael accepted, on the condition that if he couldn't make it profitable, he would be allowed to shut it down! He also chose to work for a percentage of profits rather than for a salary from the money losing business.

Michael then began to study Southwest Air, the most profitable airline in its industry. When Michael recently visited us and, when we asked, he described the epiphany he had at Love Field in Dallas more than twenty years ago when a Southwest Air plane landed. The Southwest Air plane was immediately surrounded by its ground crew that Michael thought looked like swarming locusts! The Southwest Air plane was quickly prepared for its next flight; its new passengers boarded; and the plane took off for its next destination in about half the time other airlines needed to prepare their planes for flight. Michael immediately grasped the reason Southwest Air planes produced more revenues and profits than others' planes. It was because they

flew on average two more short haul flights every day than others! Michael put that lesson into practice at Ryanair. In the hub airports where his airline had previously operated, the inefficiencies of those well-located facilities made it impossible to turn around a plane for takeoff in less than an hour. Ryanair then began to operate from less convenient and less crowded but more efficient regional airports. His goal was to turn around Ryan's planes in less than 25 minutes! Further, while flag carriers which land in hub airports pay an ever increasing amount per passenger, each year to use those facilities, *Ryanair is paid to land* at regional airports that are seeking jobs and tourists! Ryanair passes those savings on to its passengers, with significantly lower fares and better service. Of course, its customers need to be willing to travel using airports that are a little less convenient. While competitive flagship airlines are losing money or are marginally profitable, Ryanair is profitable and growing quickly.

We think our portfolios of about 400 investments in competitively advantaged companies with big growth opportunities are operated by hundreds of entrepreneurial executives who will somehow find a way to make those businesses successful. None of these executives are exactly like Michael, which I am certain you could tell in an instant after meeting him. But, they are, nevertheless, terrific executives whom we have confidence will be able to overcome whatever "insurmountable" issues they encounter...and, in most instances, the businesses they operate will become much larger than at present. Of course, there can obviously be no assurance this will be the case.

*"There is no such thing as a dumb question."* Jay Pritzker. Chairman and Founder. Hyatt Hotels Corporation. 1993.

After graduating from Harvard University, Mark Hoplamazian earned his MBA in 1989 from the University of Chicago's Booth School of Business. At Booth, Mark became friendly with Tom Pritzker, who then recruited Mark as a young executive for The Pritzker Organization. When no one in the Pritzkers' heavily Jewish family office could

pronounce or spell Mark's Armenian Christian last name, Tom nicknamed him "Steinberg." The Pritzker Organization's flagship investment then, as now, was Hyatt Hotels Corporation.

Early in Mark's career, Jay Pritzker, Tom's dad and the founder of that organization, asked Mark to take part in a meeting between Sam Zell, who at the time was Itel Corporation's Chairman, and Jay. Soon after that meeting began, Mark hesitantly asked Sam a pointed question. After Sam answered, Jay asked Mark to leave the room. About an hour later, after Jay's meeting with Sam had ended, Jay called Mark and asked him to come back. When Mark returned to Jay's office, he apologized for asking what he thought was a dumb and embarrassing question. Jay responded with what Mark still considers the *most valuable business advice* of his career, "*There is no such thing as a dumb question.*" Jay explained that because Sam's answer to Mark's question was so contrary to what he had expected, it enabled Jay to invest in Itel at an exceptionally attractive price. This was since Jay believed Itel needed the proceeds from a Pritzker investment to unwind a disadvantageous deal that Sam had made previously with Michael Dingman.

After working for the Pritzker family for more than seventeen years, Mark clearly understood the culture of that family's organization. It was not surprising, as a result, that in 2006 Mark was appointed Hyatt Hotel Corp.'s CEO. This was although the talented executive had no prior direct hotel operating experience. "Not growing up in the hotel business was a huge advantage," Mark explained. It enabled him to travel for almost nine months meeting the managers of the geographically diverse, 483 unit, Hyatt Hotel chain and ask them what were "ostensibly dumb questions." He obviously learned that early lesson from Jay well that "there is no such thing as a dumb question."

Hyatt Hotel's managers' answers to Mark's questions have enabled him to create competitive advantage for Hyatt by offering its guests difficult to replicate services.

They have even created a sub-brand, Andaz, which in the Tibetan language means, "as you like it"...and just as clearly reflects the Hyatt culture. Hotels have become a mature and cyclical business in the United States. Hyatt, with the best balance sheet in its industry and a significantly smaller "footprint" than its competitors Hilton, Marriot and Starwood, has grown its units by about 25% since Mark was appointed CEO. About 40% of the new Hyatt hotels are managed properties located in India and China. India and China are clearly hotel growth markets since each nation has a small fraction of the hotel rooms in America. This is although both countries have about four times the population of our country. Mark's efforts are also having an impact on the company's core business customers. His efforts to train his staff to provide "as you like it" services to their guests are beginning to receive very favorable reviews from its business guests and increase their lengths of stay. This is quite important to the chain's profitability since it will cost them less to put "heads in beds."

*Investigate before you invest. New York Stock Exchange.*

Before we invest in a publicly-owned business for the long term, we do what the New York Stock Exchange used to recommend to its customers, "Investigate before you invest." To us, this means asking managements lots and lots of questions, just like Mark Hoplamazian did of Hyatt Hotels' managers when he became Hyatt's CEO.

The Baron research effort is similar to the effort a college student makes in a classroom. It's about being curious and interested in the individuals to whom you are speaking as well as their businesses. It's asking them questions you would like answered if you were to own an entire company...not just a few shares in a publicly-held business.

"Why are you still here?" we asked Verisign's wealthy founder, an individual who had returned to lead his business after prior management "had mortgaged the golden egg to buy other businesses not as

good as this Internet domain registry...instead of investing in a fertility drug so the goose that laid the golden egg could produce more eggs!"

"How is Colfax able to operate its factories more efficiently than others?" we asked its Co-founder and Chairman Mitch Rales. Mitch was also the Co-founder with his brother Steve of Danaher. Mitch then described how it had taken 24 hours to change production lines from making one product to another and how, after making a few low cost and easy changes, his team was able to reduce turnaround time to less than an hour! He also described to us his as well as his brother's and dad's backgrounds and told us the only other person who asked similar questions to ours and was seeking to understand what made him and his brother tick was Mike Milken before lending them money!

Arch Capital's Dinos Iordanu recently described to our analysts how he met me in 2001. Before we invested in his business, we asked him all sorts of personal questions about how he came to America from Cyprus; whether or not his wife had a job; and how big was his house? He told our analysts that "Ron was trying to get a sense of me. He wanted to understand how I viewed risk. No one else asked us such questions. They were the right questions since you were investing in our business, which was assuming underwriting risk on your behalf." We got it right with Dinos and have about quadrupled our money in the past twelve years, not exactly the most propitious time to invest in stocks! Of course, there can be no assurance that future investments will be as profitable...although you can be assured that we will continue to work hard to try to achieve similar results.

*Baron Investment Conference 2013. November 8, 2013. Metropolitan Opera House. New York City.*

We hope you will be able to attend our 22nd annual investment conference on November 8. This meeting is designed to allow you to meet and question executives of businesses in which your hard-earned

savings have been invested. Also, to meet and question us as your investment managers and advisors about our investment process and our businesses. You will have a chance to ask us all questions...no holds barred. Our speakers that Friday morning as usual are executives of businesses in which our firm has significant investments on behalf of our shareholders. This year's speakers include Mitchell Rales, Co-founder and Chairman, Colfax, an industrial machinery business focused on infrastructure; Andrew Florance, Founder and CEO, Costar, commercial real estate's leading information service provider; Peter Carlino, Founder and CEO, Penn National Gaming, a leading regional gaming company. There will be an additional speaker announced before the end of August. We hope you will keep in mind when listening to them the growth opportunities of their businesses and what is unique about their businesses that limits competitive threats. Competitive advantage provides businesses with unusual "pricing power" and enables them to grow faster and remain unusually profitable.

When listening to and then questioning our speakers...and portfolio managers, Linda and me after lunch...we expect you to judge us as well...no questions are off limits...so that you will be able to determine whether Baron Funds remains a suitable and attractive investment for your families' hard-earned savings. As we always tell our guests, we hope you will regard this day as one to "kick the tires" of your investments in Baron Funds.

During dinners Thursday evening before our meeting and during the early part of that Friday morning, we have arranged special programs for our institutional shareholders, consultants, registered investment advisers and financial advisers. They will have a chance to meet and speak one on one with our analysts and portfolio managers. Same rules. No holds barred with questions. Our analysts and managers will be available throughout the rest of Friday to answer any questions you may have.

Finally. The entertainment. As usual, we think it will be very cool. Also as usual, it

## Letter from Ron

will be at our expense, not yours. Also as usual, it will be a surprise. Both at lunch and at the end of the day. No, we can't tell you who it is. Only Linda and I know for sure. Linda because she signs the contracts. Me because I choose it and figure out how to pay for it.

We hope we'll see you in New York at the Met on November 8, 2013. But, for those of you who can't attend this year, in addition to watching by webcast from the Baron Funds website (excluding entertainment),

you can get a sense of our meeting by watching CNBC's Squawk Box that morning from 6 AM to 8:30 AM New York time. Becky Quick and I will be interviewing several executives with whom Baron Funds has invested successfully and with whom we hope to become even more successful... although we can't promise that. We advertise our efforts to "invest in people, not just buildings." We hope when you attend our annual meetings or watch on CNBC or on our website, you will then understand

the characteristics of the people and their businesses that are most likely to make them successful. See you November 8<sup>th</sup>.

Respectfully,



Ronald Baron  
CEO and Chief Investment Officer  
Baron Funds  
July 23, 2013

P.S. For your free registration, please visit [www.BaronFunds.com/register](http://www.BaronFunds.com/register) or call 800-99-BARON, Option 1. Advanced registration is required. Preferred seating is available to those who qualify.

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*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).*

Portfolio holdings as a percentage of net assets as of June 30, 2013 for securities mentioned are as follows: **Ryanair Holdings plc** – Baron Opportunity Fund (1.1%), Baron Partners Fund (2.3%\*), Baron International Growth Fund (3.8%); **Hyatt Hotels Corp.** – Baron Asset Fund (1.8%), Baron Partners Fund (6.9%\*), Baron Focused Growth Fund (6.5%), Baron Real Estate Fund (3.9%); **VeriSign, Inc.** – Baron Asset Fund (1.1%); **Colfax Corp.** – Baron Asset Fund (2.1%), Baron Growth Fund (1.8%), Baron Focused Growth Fund (5.5%); **Arch Capital Group Ltd.** – Baron Asset Fund (3.3%), Baron Partners Fund (8.7%\*), Baron Growth Fund (3.1%), Baron Focused Growth Fund (3.5%), Baron International Growth Fund (1.4%); **CoStar Group, Inc.** – Baron Partners Fund (4.4%\*), Baron Growth Fund (1.9%), Baron Opportunity Fund (2.3%); **Penn National Gaming, Inc.** – Baron Partners Fund (3.6%\*), Baron Growth Fund (2.1%), Baron Small Cap Fund (3.2%), Baron Focused Growth Fund (2.2%), Baron Real Estate Fund (0.5%); **Oaktree Capital Group, LLC** – Baron Growth Fund (0.9%). \* % of Long Positions.

Net realized and unrealized gains for **Arch Capital Group Ltd.** as of June 30, 2013 (\$ in millions) as follows: Baron Asset Fund, \$90.1; Baron Growth Fund, \$185.2; Baron Small Cap Fund, \$12.3; Baron Fifth Avenue Growth Fund, \$0.1; Baron Partners Fund, \$109.9; Baron Focused Growth Fund, \$4.1; Baron International Growth Fund, \$0.5.