Baron Fifth Avenue Growth Fund

DEAR BARON FIFTH AVENUE GROWTH FUND SHAREHOLDER:

PERFORMANCE

We had a good year.

The broader U.S. equities had a good year as well, but we had a better year. We made the *Wall Street Journal's* "Category Kings" for 2012 total return in the Large Cap Growth-Equity Funds category. My 11 year-old was disappointed to learn that it did not entitle us to being addressed as "your majesty" (dashing his hopes of getting his friends to address him as "your royal highness"). Jeff Kolitch on the other hand... You can view "his majesty's" letter in this report, a few pages after this one (although, it would not surprise us if it were printed now a few pages ahead of ours).

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

	Baron Fifth Avenue Growth Fund ^{1,2}	S&P 500 Index ¹	Russell 1000 Growth Index ¹
Three Months ³	0.42%	-0.38%	-1.32%
One Year	20.85%	16.00%	15.26%
Three Years	9.19%	10.87%	11.35%
Five Years	0.84%	1.66%	3.12%
Since Inception (April 30, 2004)	4.33%	5.12%	5.56%

For the year ended December 31, 2012, the Fund returned 20.85%, outperforming the S&P 500 and the Russell 1000 Growth Indices by 4.9% and 5.6%, respectively. Most of this outperformance (95% and 89%, respectively), came from stock selection with the balance coming from the effect of sector allocation. In response to a recent query from our President and COO, Linda Martinson, I struggled to articulate the major themes or trends that this portfolio is positioned to take advantage of, should they occur in 2013 ("Applefication of the world is not a theme," she said. "It was until

Performance listed in the table is net of annual operating expenses. Annual operating expense ratio for the Retail Shares as of September 30, 2011 was 1.59%, but the net annual expense ratio is 1.30% (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.

- † 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 S&P 500 Index measures the performance of 500 widely held large-cap U.S. companies and the Russell 1000® Growth Index of large-sized U.S. companies that are classified as growth. The indexes and the Fund are with dividends, which positively impact the performance results.
- 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.



two months ago," I mumbled illegibly, feverishly searching for my copy of last quarter's "Letter from Ron"). Sure, increased e-commerce penetration, plastic gaining share of payments from paper, proliferation of DNA sequencing, and even real interest rates turning positive again would likely create tailwind and benefit the Fund, but this is not how we think about it. We focus on uniqueness, sustainability of competitive advantage, and a company's ability to "monetize" that advantage. Identifying potential source of mispricing and insisting on margin of safety by only buying at a significant discount to our estimate of intrinsic value is what we try to do with every investment. We expect stock selection rather than sector exposures to account for most of performance attribution, good and bad, most of the time.

The above is consistent across all Baron Funds and bottom up stock selection process is the DNA of this firm. There is no denying, however, Jamie Stone's depth and versatility in pointing out major trends in Energy, or "his majesty," Jeff Kolitch's solid arguments behind anticipated developments in the world of Real Estate. Unfortunately, the world of large cap remains a mystery to us, and unless "Applefication" will become a trend again, we will continue to offer little to nothing in this regard. More on Apple, Inc., though, below.

Table II.

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

	Quarter End Market Cap (billions)	Percent Impact
Illumina, Inc.	\$6.9	0.54%
Visa, Inc.	122.9	0.49
New Oriental Education & Technology Group	3.1	0.38
Liberty Media Corp.	13.9	0.36
Facebook, Inc.	57.7	0.31

We have already written extensively about **Illumina**, **Inc.** twice this year. Back to the top contributor list it goes as investors priced in renewed takeover speculation and the avoidance of fiscal cliff, which would have likely resulted in cuts to National Institute of Health funding. We have no insight of any kind into Roche's or other



potential acquirers' true intentions, but we do believe that Illumina is by far the best provider of DNA sequencing instruments and genetic analysis tools today. In our experience, to acquire/own the best typically requires paying a significant premium. Shares of Illumina were up 82.4% in 2012, and it was the fourth largest contributor to the Fund's performance. We continue to believe the DNA sequencing market is poised for explosive growth and Illumina will remain the market leader.

Shares of **Visa, Inc.**, another top five contributor to annual returns, rose 50.5% last year. As concerns about litigation (settled) and impact of regulations (the Durbin Amendment) subsided, investors focused more on fundamentals, which have remained strong throughout the year. As the owner and operator of the largest electronic payments network in the world, Visa is one of the likely beneficiaries every time someone answers the question "How would you like to pay for that?" with the word "plastic." The fact that the company's revenues and earnings are linked to the notional amount processed on its network, providing a natural inflationary hedge, isn't bad either.

The stock of **New Oriental Education & Technology Group** rebounded in the fourth quarter, rising 16.6%. Even after that, it was one of our largest detractors on the year (down 17.4%) for reasons that we covered in detail in our previous letter. While we remain optimistic about the company's long-term prospects, we have reduced our position (we bought some last quarter on weakness) primarily because we needed to fund other investments that we felt offered a better risk-reward.

Liberty Media Corp. is a holding company with interests in media and communications companies managed by John Malone. Shares appreciated 48.6% in 2012 (good for 6th best in the Fund), largely as a result of strong performance from 50% owned Sirius XM Radio and the anticipation of an impending spin-out of Starz to Liberty's shareholders, which is expected to unlock further value.

Table III.

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

	Quarter End Market Cap (billions)	Percent Impact
Apple, Inc.	\$501.4	-1.64%
Better Place, Inc.	0.0	-0.70
Google, Inc.	233.1	-0.41
Citrix Systems, Inc.	12.3	-0.32
CME Group, Inc.	16.9	-0.30

We have written about **Apple, Inc.** every quarter this year. Of course, it was in the prior section (i.e., contributors). While the shares declined 19.9% during the quarter, they still ended the year up 32.6%, which combined with our large weighting in the stock made it our single largest contributor in 2012. There are many reasons why Apple gave up some of its gains in the last three months. Increased competition in smartphones and tablets, lack of "known" new products, concerns about sustainability of company's margins and general profitability, the perverse but real

incentives to take profits to pay a lower capital gains tax created by the uncertainty of the fiscal cliff, just to name a few. Beyond the obvious short-term issues, we recognize the creeping doubts about Apple's ability to remain one of the most creative and innovative consumer products companies in the world, particularly without the visionary leadership of Steve Jobs. We even admit to having some doubts of our own. But Apple is not *priced* as an innovator or even a growth company at all. At 9.2% *current* Free Cash Flow Yield (12.8% FCFY ex cash), we don't *need* growth. Perhaps no growth isn't conservative enough? Maybe, but that's not what our research indicates. Apple is still a platform company with a large and growing eco-system, a trusted and admired brand, and massive positive optionality (i-TV, i-payments, i-car?) that we are getting for free. At a meaningful discount to the market (i.e., an average company) on every metric, Apple continues to offer one of the more attractive risk-rewards in large cap, in our view.

Better Place, Inc. is the first and only global end-to-end electric vehicle (EV) infrastructure provider with operating networks in Israel and Denmark. We made a small investment in Better Place in late 2011, although we have followed the company since its inception in 2007 and its founder, Shai Agassi, for many years before that. The creative business model and an innovative solution that would likely disrupt and dislocate the giant car industry made this by far our highest potential reward and highest risk investment. The company fell behind its stated deployment schedule and experienced higher costs than originally anticipated. During the fourth quarter, the company's two largest shareholders lost patience and ousted Better Place's CEO, in the process, likely causing irreparable damage to the company's prospects. We have written this investment off (carried at a nominal value representing less than 0.01% of the Fund). It cost us 70 basis points.

Google, Inc., Citrix Systems, Inc., and CME Group, Inc. all made an appearance on the top quarterly contributors list earlier in the year, and all three contributed positively to returns in 2012. All three reported soft third quarter results and stocks underperformed due to concerns about mobile monetization in the case of Google, low trading volumes in a near-zero interest rate environment in the case of CME, and macro/fiscal cliff uncertainties affecting corporate IT spending/investments for Citrix. We have added to all three positions during the quarter.

PORTFOLIO STRUCTURE

The portfolio is constructed on a bottom-up basis, with the quality of ideas and conviction level having the highest roles in determining the size of each individual investment. Sector weights tend to be an outcome of the portfolio construction process and are not meant to indicate a positive or a negative "view."

During the quarter, compared to the Russell 1000 Growth Index, the Fund was overweight Information Technology, Consumer Discretionary and Financials, and underweight Consumer Staples, Health Care, Industrials, Telecommunication Services, and Energy. For the calendar year 2012, compared to the Russell 1000 Growth Index, the Fund was overweight and underweight the above sectors.

Baron Fifth Avenue Growth Fund

The top 10 largest positions represented 42.2% of the Fund, top 20 were 69.4% and we exited the year with a total of 40 holdings.

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

	Quarter End Market Cap (billions)	Quarter End Investment Value (millions)	Percent of Net Assets
Apple, Inc.	\$501.4	\$3.9	6.2%
Google, Inc.	233.1	3.6	5.7
Amazon.com, Inc.	113.8	3.1	5.0
Visa, Inc.	122.9	2.5	4.0
Monsanto Co.	50.6	2.4	3.8
Illumina, Inc.	6.9	2.4	3.8
Equinix, Inc.	10.0	2.2	3.5
YUM! Brands, Inc.	30.0	2.1	3.4
Brookfield Asset Management, Inc.	22.9	2.1	3.4
priceline.com, Inc.	31.0	2.1	3.4

RECENT ACTIVITY

During the fourth quarter we initiated positions in Ralph Lauren Corp. and Starbucks Corp., and eliminated our holdings in Mead Johnson Nutrition Co. and Baidu, Inc. Ralph Lauren is a leading lifestyle brand. The company designs, sources and sells a variety of apparel and other consumer products. We believe Ralph Lauren is poised to capitalize on significant investments it has made into distribution (especially retail, licensing, and digital/e-commerce), which give the company a viable competitive advantage that is underappreciated by the market. Starbucks, we would argue, is an iconic lifestyle brand in its own right. With over 18,000 stores world-wide, Starbucks continues to re-invent the premium coffee experience. The return of Howard Schultz has proven to "reactivate" the innovation gene that the company seemed to have lost after his departure. New Concepts, CPG, Single serve, all give us increased confidence that the re-accelerated growth we have seen should be sustainable for the foreseeable future.

Mead Johnson Nutrition and Baidu were eliminated to make room for new investments. It is worth noting that we continue to own shares of Baidu in the Baron Global Advantage Fund.

Table V.

Top net purchases for the quarter ended December 31, 2012

	Quarter End Market Cap (billions)	Amount (millions)
Ralph Lauren Corp.	\$13.7	\$1.6
Starbucks Corp.	39.9	1.1
priceline.com, Inc.	31.0	0.7
Google, Inc.	233.1	0.7
Wynn Resorts Ltd.	11.3	0.7

Table VI.

Top net sales for the quarter ended December 31, 2012

	Quarter End Market Cap or Market Cap When Sold (billions)	Amount (millions)
Mead Johnson Nutrition Co.	\$13.7	\$-0.9
Baidu, Inc.	37.2	-0.8
New Oriental Education & Technology Group	3.1	-0.4

OUTLOOK

Our goal is to maximize long term returns without taking significant risks of permanent loss. We will continue to focus on identifying and investing in unique companies with sustainable competitive advantages that we believe have the ability to reinvest capital at high rates of return. We are optimistic about the long term prospects of the companies we are invested in and continue to search for new ideas and investment opportunities.

Thank you for investing in the Baron Fifth Avenue Growth Fund.

Sincerely,

Alex Umansky, 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.

The Fund invests primarily in large cap equity securities which are subject to price fluctuations in the stock market. The Fund may not achieve its objectives. 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 managers 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.

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