# Baron Global Advantage Strategy

September 30, 2017

## Dear Investor:

## Performance

Make it three in a row.

Baron Global Advantage Strategy (the "Strategy") returned 8.15% in the September quarter and has returned 37.42% year-to-date. These results compare favorably to the returns of our benchmarks, MSCI ACWI Growth and MSCI ACWI Indexes, which appreciated 5.8% and 5.2%, respectively, for the third quarter, and 22.0% and 17.3%, respectively, over the first nine months of the year.

Quarterly performance was led mostly by long held core investments **Alibaba Group Holding Limited** (up 23%), **TAL Education Group** (up 65%), **Baidu, Inc.** (up 38%) and **ASML Holding N.V.** (up 31%); although more recent additions **Take-Two Interactive Software, Inc.** (up 39%) and **JM Financial Limited** (up 16%) made significant positive contributions as well. We did have an unusually high number of detractors over the last three months. Though they were all smaller positions that did not cause material damage to the overall returns, it prompted us to go through a rigorous quality control exercise, which resulted in the elimination of eight holdings.

Since the election of Prime Minister Narendra Modi in May of 2014, we have been investing more time into researching Indian companies. There is a lot to like about the world's largest democracy. For starters – compelling demographics. The national median age is just 27.6 years, with more than two thirds of the Indian population below the age of 35. Mr. Modi ran on a platform of political and economic reform and the early returns have been promising. We think it is still very early, but we are starting to see progress and real changes taking hold. More entrepreneurs are getting access to capital and investing in their businesses for the long term. Similar to China over the last decade, we are now observing the beginning stages of the rise in disposable incomes and the emergence of the middle class. We think many companies in India are starting to look really attractive from the long-term perspective.

**Table I.**
**Performance**
**Annualized for periods ended September 30, 2017**

| | Baron Global Advantage Strategy (net)[1] | Baron Global Advantage Strategy (gross)[1] | MSCI ACWI Growth Index[1] | MSCI ACWI Index[1] |
|---|---|---|---|---|
| Three Months[2] | 8.15% | 8.27% | 5.76% | 5.18% |
| Nine Months[2] | 37.42% | 37.68% | 21.96% | 17.25% |
| One Year | 27.98% | 28.22% | 19.11% | 18.65% |
| Three Years | 11.73% | 11.82% | 9.18% | 7.43% |
| Five Years | 15.44% | 15.50% | 11.15% | 10.20% |
| Since Inception (September 30, 2004)[3] | 16.06% | 16.12% | 12.66% | 11.90% |

Since the inception of the Strategy, we have had little to no exposure to Indian companies for a variety of reasons. But, over the last nine months, we made four investments and exited this quarter with 7.3% of the Strategy invested in companies domiciled in India, third highest after only the U.S. and China. At the end of the quarter, at 2.2%, **Housing Development Finance Corporation Limited** (HDFC Ltd) was our largest investment in India.

Incorporated in 1977 as the first specialized mortgage company in India, today HDFC Ltd is a $40 billion financial conglomerate with prospering mortgage origination, asset management, life insurance, and real estate businesses. At roughly 20% of the market, it is the largest housing finance company in the country with gross loans in excess of $45 billion. We think the backdrop is particularly favorable, as India's 9% penetration rate of mortgages as a percent of nominal GDP is one of the lowest in the world. It is 20% in Thailand, 22% in China, 32% in Malaysia, mid-60s in the U.S. and U.K., and 90% in Denmark. Recent government support towards housing through meaningful tax incentives, and partnerships with the private sector

*For Strategy reporting purposes, the Firm is defined as all accounts managed by Baron capital Management, Inc. ("BCM") and BAMCO, Inc. ("BAMCO"), registered investment advisers wholly owned by Baron Capital Group, Inc. As of September 30, 2017, total Firm assets under management are approximately $25.3 billion. The Strategy is a time-weighted, total return composite of ail large-cap accounts greater than $1 million using our standard investment process. Since 2010, accounts in the Strategy are market-value weighted and are included on the first day of the month following one full month under management. Prior to 2010, accounts were included on the first day of the quarter after one full quarter. Gross performance figures do not reflect the deduction of investment advisory fees. Actual client returns will be reduced by the advisory fees and any other expenses incurred in the management of the investment advisory account. A full description of investment advisory fees is supplied in our Form ADV Part 2A. Valuations and returns are computed and stated in U.S. dollars. Performance figures reflect the reinvestment of dividends and other earnings. The Strategy is currently composed of one mutual fund managed by BAMCO and separately managed accounts managed by BCM. BAMCO and BCM claim compliance with the Global Investment Performance Standards (GIPS®). To receive a complete list and description of the Firm's strategies or a GIPS compliant presentation please contact us at 1-800-99BARON.*

*Performance data quoted represents past performance. Current performance may be lower or higher than the performance data quoted. Past performance is no guarantee of future results.*

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

[1] The indexes are unmanaged. The S&P 500 Index measures the performance of 500 widely held large cap U.S. companies and the Russell 1 000® Growth Index of large-sized U.S. companies that are classified as growth. The indexes and the Strategy are with dividends. which positively impact the performance results. Russell Investment Group is the source and owner of the trademarks, service marks and copyrights related to the Russell Indexes. Russell is a trademark of Russell Investment Group.

[2] Not annualized.

[3] The Strategy has a different inception date than its underlying portfolio, which is April 30, 2004.

have made housing significantly more affordable, which combined with rising annual incomes, will likely accelerate the demand for mortgages. HDFC Ltd's mortgage book has been growing consistently between 16% to 18% and we expect this growth to rise over the next few years. HDFC Ltd is the only AAA-rated private mortgage issuer in India and, as such, has a significant funding advantage over its competitors which allows the company to issue loans at both lower rates and higher profit margins. The company enjoys the best cost-to-income ratio (approximately 7% compared to 13% to 16% for its peers) due to its scale and distribution advantages; and we think their management team, whom we met with over half a dozen times in the last two years, is second to none! There is also positive optionality as the company gets ready to float parts of its Life Insurance and Asset Management businesses. We believe this is the right company at the right time in the right place with a compelling investment case that we expect to own for many years to come.

**Table II.**
**Top contributors to performance for the quarter ended September 30, 2017**

| | Quarter End Market Cap (billions) | Percent Impact |
|---|---|---|
| Alibaba Group Holding Limited | $442.3 | 2.18% |
| TAL Education Group | 16.9 | 1.91 |
| Baidu, Inc. | 85.9 | 0.76 |
| ASML Holding N.V. | 73.9 | 0.61 |
| Facebook, Inc. | 496.2 | 0.58 |

Shares of **Alibaba Group Holding Limited**, the largest retailer and e-commerce company in China, appreciated in the third quarter. Though we can point to little material change over the last three months, the shares rose another 23%, and the stock price has now nearly doubled in 2017. Alibaba owns and operates the two largest Chinese online shopping platforms and has a majority share in the profits of Ant Financial, the owner and operator of China's largest third-party online payment provider Alipay. The company benefits from strong mobile and advertising growth (700 million mobile internet users in China with a growing $5 trillion annual mobile payment volume), which drives positive optionality beyond core e-commerce. We expect continued rapid growth in all areas, combined with a high re-investment rate in newer market segments such as groceries, logistics, and cloud computing. Though we genuinely wish the stock's rapid ascent was less torrid, we continue to be optimistic about Alibaba's long-term prospects and it remains the largest investment in the Strategy.

**TAL Education Group** is a leading Chinese K-12 tutoring company, operating over 550 learning centers in 35 cities across China. Shares of TAL increased 65% during the quarter, and the stock price has nearly tripled in 2017. Similarly to Alibaba above, we believe the stock has undergone a major re-rating this year. TAL continues to demonstrate rapid growth in student enrollments of approximately 62%, opening 60 new learning centers while expanding the existing learning centers, and rapidly gaining share in the fragmented Chinese K-12 tutoring market. We maintain conviction in TAL as a tutoring market leader with opportunity to continue gaining market share for many years due to the strength of its brand.

**Baidu, Inc.** is the dominant search engine in China. In addition to search, Baidu is the leader in online video, artificial intelligence, and autonomous driving in China. The company also has a new advertising product that provides news and other information, customized to Chinese consumer appetites. Shares of Baidu were up 38% in the quarter, due to expectations of accelerating revenue growth and improving overall financial results. Based on recent Chinese government regulations, Baidu had to implement considerable changes to their search algorithms in certain categories, which caused a significant disruption to its business. With the changes finally behind it, Baidu can once again start to grow at a faster pace. Additional optionality exists as Baidu's management has undergone a strategic review and is now in the process of focusing more on its core businesses, and monetizing its less strategic assets.

**ASML Holding N.V.** designs and manufactures semiconductor production equipment. ASML specializes in photolithography equipment, where light sources are used to photo-reactively create patterns on wafers which ultimately become printed circuits. This is really cool stuff. Shares of ASML appreciated 31% after another quarter of strong order flow from the next generation Extreme Ultra Violet (EUV) lithography product line. ASML continues to be the standard in the next generation lithography that is required for chip production at 5 nanometer node and below. We maintain high conviction in this investment as we believe ASML is the de-facto monopoly supplier of a required tool for the future of the semiconductor industry.

Shares of **Facebook, Inc.**, the world's largest social network and media company, appreciated 13% during the quarter, driven by improvements in consumer engagement and monetization. Facebook continues to be the largest beneficiary of the ongoing consumer shift to mobile and utilizes its leadership position to provide targeted marketing capabilities to global advertisers at scale. Facebook is in the early stages of monetizing online video and Instagram, which are both starting to contribute to incremental revenue growth, and is taking advantage of WhatsApp and Oculus as additional growth opportunities.

**Table III.**
**Top detractors from performance for the quarter ended September 30, 2017**

| | Quarter End Market Cap or Market Cap When Sold (billions) | Percent Impact |
|---|---|---|
| Glaukos Corporation | $ 1.1 | –0.36% |
| Sage Therapeutics, Inc. | 2.3 | –0.26 |
| Acxiom Corporation | 1.8 | –0.24 |
| Snap, Inc. | 14.2 | –0.19 |
| Luxoft Holding, Inc. | 1.6 | –0.19 |

Shares of **Glaukos Corporation** declined 20% in the third quarter. Glaukos is a pioneer of minimally invasive glaucoma surgery. This quick procedure implants a stent, called the "iStent," into the eye's clogged outflow drain to reduce pressure and slow glaucoma progression. Glaukos has run into execution issues as a Medicare "gifted" price increase (applied universally to Average Selling Prices) has caused commercial insurance reimbursement issues, leading to volume deceleration and underperformance. Glaukos is currently only approved for a subset of the market with the iStent and has produced data for another next generation product dubbed the iDose, hence our continued conviction for the company's long-term trajectory and our expectations for the broader insurance coverage.

**Sage Therapeutics, Inc.** is focused on developing novel drugs for central nervous system disorders. After a big run in the first half of the year the shares pulled back 22% in the September quarter. The company's initial focus was on the treatment of a rare medically induced coma caused by SRSE (super refractory status epilepticus) and on post-partum depression. Recent developments have been negative after the first Phase 3 trial in SRSE failed. However, we are more optimistic about the pivotal data in post-partum and major depression expected to be released this quarter. Additionally, Sage has announced expansion into disease indications like Parkinson's and tremor. Regardless of volatility, we retain strong conviction in Sage's ultimate probability of success.

**Acxiom Corporation** is a leader in marketing data services and identity management for enterprises. Shares of Acxiom declined 12% in the quarter as the company's legacy marketing services business is now expected by analysts to be down year-over-year and the data sales business is expected to grow at a slower rate due to a change in contractual terms with one of their larger customers. We decided to exit our investment.

**Luxoft Holding, Inc.** provides outsourced software development to business customers using highly-skilled, low-cost employees primarily in Eastern Europe and Russia. The stock fell 20% after the company reported disappointing financial results. Revenue growth slowed for several large customers, margins declined, and full-year guidance was cut. We exited the position.

## 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 or country weights tend to be an outcome of the portfolio construction process and are not meant to indicate a positive or a negative "view."

The top 10 positions represented 48.6% of the Strategy, the top 20 were 70.1%, and we exited the quarter with 40 holdings. Over 94% of the Strategy's assets are invested in stocks in the Information Technology, Consumer Discretionary, Financials, and the Health Care sectors, as classified by GICS, with over half of the assets invested in companies that are domiciled outside of the United States.

**Table IV.**
**Top 10 holdings as of September 30, 2017**

| | Quarter End Market Cap (billions) | Quarter End Investment Value (millions) | Percent of Net Assets |
|---|---|---|---|
| Alibaba Group Holding Limited | $442.3 | $3.1 | 10.0% |
| Amazon.com, Inc. | 461.8 | 1.9 | 6.1 |
| Naspers Limited | 94.8 | 1.7 | 5.4 |
| Facebook, Inc. | 496.2 | 1.7 | 5.4 |
| Alphabet Inc. | 669.2 | 1.5 | 4.7 |
| TAL Education Group | 16.9 | 1.3 | 4.2 |
| EPAM Systems, Inc. | 4.6 | 1.3 | 4.0 |
| Ctrip.com International, Ltd. | 27.1 | 1.0 | 3.1 |
| Baidu, Inc. | 85.9 | 1.0 | 3.0 |
| Constellation Software, Inc. | 11.6 | 0.8 | 2.7 |

## Exposure By Country

**Table V.**
**Percentage of securities by country as of September 30, 2017**

| | Percent of Net Assets |
|---|---|
| United States | 44.5% |
| China | 22.2 |
| India | 7.3 |
| South Africa | 5.4 |
| Israel | 5.1 |
| Canada | 2.7 |
| Netherlands | 2.4 |
| United Kingdom | 1.7 |
| Taiwan | 1.6 |
| Japan | 1.6 |
| Argentina | 1.2 |

## Recent Activity

We initiated 15 net new investments in the Strategy in the first six months of the year. The intent was to upgrade the opportunity set without sacrificing quality of ideas, while managing the risk around position sizes of some of the largest outliers. With quality control as the battle cry, we added only one new name this quarter while jettisoning eight others. In our defense, only two of the eight purges were added this year so the overwhelming majority of new ideas survived the added scrutiny, and we feel a lot better about a tidy 40 name portfolio. We also added to 23 existing investments and trimmed six others.

**Table VI.**
**Top net purchases for the quarter ended September 30, 2017**

| | Quarter End Market Cap (billions) | Amount Purchased (thousands) |
|---|---|---|
| Vantiv, Inc. | $ 12.5 | $405.4 |
| Naspers Limited | 94.8 | 352.7 |
| Facebook, Inc. | 496.2 | 317.4 |
| Baidu, Inc. | 85.9 | 313.4 |
| EPAM Systems, Inc. | 4.6 | 265.1 |

We initiated a position in **Vantiv, Inc.** during the September quarter. Vantiv is a payment processing company that provides technology solutions that enable merchants to accept electronic payments. Earlier in the quarter, Vantiv announced a transformative acquisition of the U.K. company, Worldpay, the largest payment processor in Europe. After years of researching the company, we initiated a position in Vantiv because we believe the combination will create significant shareholder value over time. These two businesses are highly complementary given Vantiv's market-leading position and growth in the U.S. and Worldpay's dominance in the U.K. and international e-commerce markets. We expect near-term expense synergies from rationalizing Worldpay's U.S. segment and longer-term revenue synergies by accelerating Vantiv's growth in domestic e-commerce.

Based in Cape Town, South Africa, **Naspers Limited** is a $95 billion conglomerate with assets in internet services, television, and digital media, as well as other technology services. Among its impressive investment portfolio is a sizable stake in India's e-commerce leader Flipkart, 29% stake in Russian publicly traded internet holding company Mail.ru, and the crown jewel of the portfolio, 34% ownership in the Chinese internet powerhouse Tencent, which at its current market price exceeds the entire market cap of Naspers. All in all, Naspers owns part or all of more than 140 additional internet assets, which equity markets appear to be assigning no value to at this time. We believe that Tencent, in particular, represents an attractive investment in and of itself, and is currently undervalued. Moreover, we think Naspers can win in many different ways and the presence of unusually large positive optionality is what gives us conviction to make it a top five position in the Strategy.

We added to our investment in **Facebook, Inc.**, the world's largest social network and media company. We believe Facebook will demonstrate continued improvements in consumer engagement and monetization. The company continues to be uniquely positioned as the largest beneficiary of the ongoing consumer shift to mobile and utilizes its leadership position to provide targeted marketing capabilities to global advertisers at scale. Facebook is in the early stages of monetizing online video and Instagram, which are both starting to contribute to incremental revenue growth, and is taking advantage of WhatsApp and Oculus as additional growth opportunities.

**EPAM Systems, Inc.** provides outsourced software development to business customers using highly skilled, potentially lower-cost employees, primarily in Eastern Europe and Russia. The company reported solid financial results with 24% organic, FX-neutral revenue growth as demand remained strong across verticals and geographies. Full-year revenue guidance was raised to reflect more favorable FX rates. We added to the position because we believe EPAM has a long runway for growth in a large, global market for next-generation software development.

**Table VII.**
**Top net sales for the quarter ended September 30, 2017**

| | Market Cap When Sold (billions) | Amount Sold (thousands) |
|---|---|---|
| FireEye, Inc. | $ 2.5 | $646.9 |
| Mobileye N.V. | 14.1 | 640.3 |
| Acxiom Corporation | 1.8 | 556.9 |
| Pacira Pharmaceuticals, Inc. | 1.5 | 273.7 |
| Luxoft Holding, Inc. | 1.6 | 221.5 |

**FireEye, Inc.**, **Acxiom Corporation**, **Pacira Pharmaceuticals, Inc.,** and **Luxoft Holding, Inc.** were all sold out of the Strategy in the third quarter. **Mobileye N.V.**'s acquisition by Intel closed during the quarter and we received our cash.

## Outlook

The first nine months of the year have been very rewarding for global growth investors, and many of our companies have performed exceedingly well. With the Strategy up over 37% year-to-date, this has undeniably been a favorable environment for the way in which we invest. After lackluster earnings growth last year, corporate profits are on pace for double-digit growth in 2017. Moreover, the outlook for 2018 is even more optimistic, driven by a reduction in corporate tax rates, improved backdrop for Financials, Energy, and Industrials companies. Though helpful if it were to happen, we are not counting on any of this. More relevant to our portfolio, digital ad spending and e-commerce growth are actually accelerating, with spending on cloud computing still growing more than 80% year-over-year. The digitization phenomenon that we believe will continue for years to come is starting to reach inflection points in many new areas. In addition to media and retail, medicine, transportation, and consumer banking are now in the midst of full blown disruptions. We believe this should favor many of the companies in which we invest.

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

Sincerely,

Alex Umansky
Portfolio Manager

*The performance of accounts in the Strategy may be materially different at any given time. Differences that may affect investment performance include cash flows, inception dates, and historical prices. Positions may not be the same or may be traded at different times. In addition, accounts in the Strategy may be pursuing similar investment strategies, but may have different investment restrictions.*

Non-U.S. investments may involve additional risks to those inherent in U.S. investments, including exchange-rate fluctuations, political or economic instability, the imposition of exchange controls, expropriation, limited disclosure and illiquid markets. This may result in greater share price volatility. Securities of small and medium-sized companies may be thinly traded and more difficult to sell. The Strategy 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 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.