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Banking on Growth in International Financials

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The surge in global Financials following the U.S. presidential election in November 2016 has drawn investor attention back to this long-out-of-favor sector. We think the sector merits this renewed consideration. International Financials have lagged significantly since the global 2007-08 financial crisis triggered by the collapse in the subprime mortgage market in the U.S. Even with the recent uptick, as of March 31, 2017, the category, as measured by the MSCI ACWI ex USA Financials Index, was still down more than 25% since its October 2007 peak, compared with the broader market, as measured by the MSCI ACWI ex USA Index, which was roughly unchanged. While their stock prices have trailed, many financial company fundamentals have continued to improve.

At 23% of the MSCI ACWI ex USA Index, Financials comprises by far the largest sector weighting in the international equities index, close to double the size of the next largest sector. As the engine providing the flow of funds that fuels business growth and economic development, the Financials sector plays an essential role in the economy. We believe the sector will continue to enjoy sustained strength as we have seen since the fourth quarter of 2016, driven by better economic conditions, gradual removal of monetary stimulus, and rising interest rates.

At Baron, we invest in international financial companies through three funds: Baron International Growth Fund, Baron Emerging Markets Fund, and Baron Global Advantage Fund. The international financial markets operate within a shifting matrix of macro-economic, geopolitical, and industry-specific forces that add layers of complexity to the investment process. To find long-term growth opportunities within this ever-changing landscape, for Baron International Growth Fund and Baron Emerging Markets Fund, we combine fundamental, bottom-up company-specific research with compelling investable themes. These themes are based on important changes or trends that suggest the potential for a significant improvement in profitability, return on capital, or growth potential. Our themes fall into two broad categories: industry-wide trends such as meaningful changes in global monetary policy; direction or changes in the credit cycle; and region- or country-specific trends such as financial reform or market-friendly shifts in political direction.

With Baron Global Advantage Fund, which typically holds only 15 or so international equities out of a total of 30-40 investments, the goal is to invest in what we believe are the best long-term growth companies anywhere in the world. The Fund currently has positions in three international financial stocks, two of which are in India. Baron Global Advantage Fund – and, in fact, all of our Funds that invest outside the U.S. – tends to favor certain emerging market countries such as India where the growth opportunity is significant. In the case of India, the emergence of the middle class has allowed it to develop its own economic eco-systems. India also skews toward younger populations, higher local savings rates, and a greater need for new infrastructure than developed countries.

As with all of our investments in the international financials space, we look for companies that we believe have significant long-term growth opportunities, sustainable competitive advantages, and experienced management teams, at an attractive valuation. In addition, within the international equities markets, we emphasize entrepreneurial management, capital efficiency and shareholder-friendly governance. We believe this multi-faceted approach is the key to successful long-term growth equity investing in international financials.

Global Monetary Policy

In an effort to prevent further deterioration of the global economy, the world's central banks responded to the 2007-08 financial crisis and ensuing recession by significantly easing monetary policies. Interest rates worldwide fell steeply. The Bank of Japan and the European Central Bank even ventured into the once-uncharted territory of negative interest rates. However, after eight years of hovering around zero, interest rates look poised to increase as policymakers from Japan and the U.S. have signaled a likely shift toward greater fiscal stimulus and an accommodation of moderately higher inflation, in response to a widening wealth gap and associated rise in global populism, in our view. An environment of higher inflation, higher interest rates, and steeper yield curves typically favors the Financials sector, particularly relative to the difficult headwinds such companies have faced since the recession.

Given our view that European monetary policy remains accommodative while growth prospects have brightened, we recently initiated a position in **BNP Paribas S.A.** of France, which we believe was offered at a particularly attractive valuation given concerns over the upcoming French elections at the time of our purchase. We are seeing the beginning of a lagged upturn in credit growth across Europe, and believe we will see rising earnings momentum and strength across Financials

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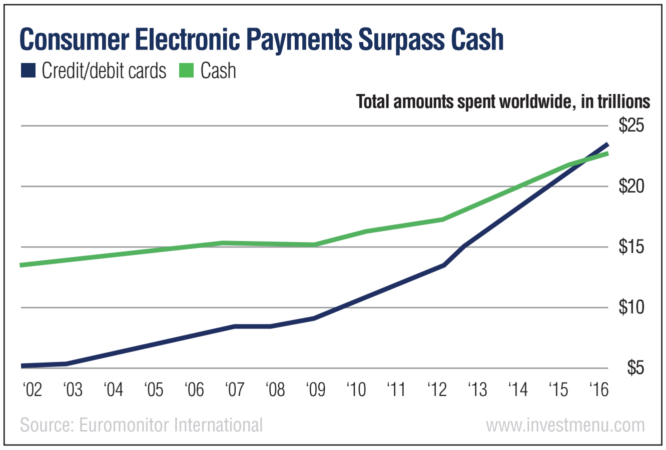
in many of the European countries as we look ahead over the next year or two, and continue to actively look for investment opportunities in the region.

We think Swiss private bank **Julius Baer Group Ltd.** is also well positioned to benefit from higher rates globally. The firm is one of the leading independent private banks, with over 5,800 employees and AuM of over CHF300 billion. Longer term, we think Julius Baer will be among the winners in the global private banking industry given its presence in fast growing geographies, stellar reputation, and scale, which we think will lead to solid net-new money growth. In addition to being positively levered to higher rates, the firm is highly cash generative, which offers strategic flexibility, including the opportunity to increase dividends, buy back shares, or engage in accretive acquisitions.

We also recently established positions in two leading Korean financial institutions, **Shinhan Financial Group Co., Ltd.** and **KB Financial Group Inc.**, both of which we believe will benefit from a reversal in the trajectory of domestic interest rates. After years of declining market rates, negligible asset growth and internal efforts to rationalize costs, we believe these companies are set to enjoy an expansion in profitability that should drive a rerating in valuation.

Technology-Driven Change

As is the case with numerous other industries, aspects of the financial industry are experiencing transformative technology-driven change, ranging from electronic trading platforms to software-as-a-service suppliers of financial intelligence to the investment community. While many of our financial technology holdings are based in the U.S., we also own U.K.-based **Worldpay Group plc.**, the largest payment processor and merchant acquirer in Europe.

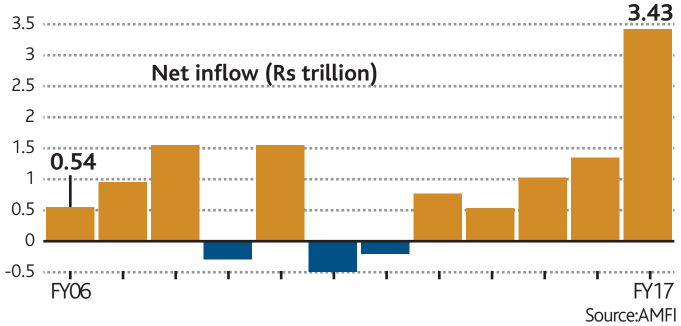


As shown in the chart above, payment methods are increasingly shifting from cash to cards worldwide. We believe this trend will continue and Worldpay will be a significant beneficiary. The company enables 400,000 merchants in 146 countries to accept electronic payments in 126 currencies by connecting them to payment networks. Worldpay is dominant in the U.K. market and has a fast growing and highly profitable e-commerce business that is benefiting from the rapid growth of online commerce. We think margins are poised for expansion driven by operating leverage, strong growth of the high-margin e-commerce segment, and a migration onto a new processing platform. Earnings should also benefit from debt repayment and a declining tax rate.

India Reforms

We are excited about the long-term opportunities in India and the potential for ongoing reforms by the Modi administration to open the door to a favorable investment cycle that will extend to several industries, including Financials. Recent progress on government initiatives to recapitalize and clean up the considerable quantity of non-performing loans has given us renewed confidence in the outlook for the sector. We are also seeing the beginnings of what we believe will be a significant shift in Indian savings from real estate and gold toward financial assets in the wake of the demonetization of the Indian rupee and the government's financial inclusion initiative, a direct effort to increase opportunity for the Indian population to invest in financial products.

Mutual Fund Inflows in India Have Surged



As seen in the chart above, net inflows into mutual funds in India in the year-long period ended March 2017 are the highest since at least 2005-06, rising 156% from a year before.

We have positions in **Kotak Mahindra Bank Ltd.** and **JM Financial Limited**, two financial services firms offering products across an array of verticals, including investment banking, securities, and asset management that we think are well-positioned to benefit from these developments. Kotak is aggressively pursuing a digital agenda, including mobile banking capabilities, which we believe will be a key additional driver of long-term growth.

We took advantage of weakness in the Indian market post demonetization to initiate positions in **Housing Development Finance Corporation Limited** (HDFC), a financial conglomerate that is India's leading housing and mortgage lender; and **HDFC Bank**

Limited, India's largest bank, which is 21.5% owned by HDFC. We have long admired the company's unassailable competitive advantages, which include best-in-class cost efficiency and risk management. We believe that India is experiencing a housing upturn, driven in part by government initiatives to stimulate industry, favorable demographic trends, and improvements in affordability. We also think there are significant growth opportunities in the company's market leading positions in other under-penetrated financial segments, including life insurance and asset management.

China Reforms

Given lack of follow through on much-needed financial reforms outlined by the Chinese government in November 2013, we have reduced our holdings of Chinese financial companies while monitoring the pace of reforms, which are intended to transition China to a more market-driven and credit sensitive system and reduce corruption. While we have divested many of our investments based on Chinese financial reform, we have retained positions in two companies that we believe will continue to benefit from factors driving growth in China's financial sector even as the pace of reform slows.

Haitong Securities Co., Ltd. is a leading firm providing securities and futures brokerage, investment banking, asset management, proprietary trading, and direct investment services. We believe the securities industry in China is still in early stages of development which provides meaningful growth opportunities such as deeper penetration of capital markets and the development of more sophisticated products. Trading volumes have fallen in response to a government crackdown on market misconduct, but we believe this headwind will prove temporary. In addition, should reforms move forward, we believe Haitong is well positioned to increase its participation in the financing of private and public enterprises, which is currently dominated by the state-owned bank sector.

China Everbright Limited is an asset management company with approximately US$11 billion in AuM, operating in Hong Kong and mainland China. The company has grown AuM at a 30% CAGR over the last five years and we believe it can maintain this impressive rate of growth as it is a big beneficiary of China's increasing demand for asset diversification. Growth in AuM for the asset management industry is expected to triple by 2020 as China pushes to internationalize the RMB and eases investment constraints for institutional/state-owned investors. In addition we believe the low interest rates that have resulted from economic stimulus, a stagnating real estate market, and a recent crackdown on so-called wealth management products will compel more Chinese households to shift assets from traditional, low-yield products such as savings accounts into professionally managed investment vehicles. Taken together, we think these trends represent a significant opportunity for asset managers such as China Everbright.

Latin America

As the leading operator of financial exchanges in Brazil, **BM&FBOVESPA SA** should benefit from the long-term development of the Brazilian capital markets, in our view. While the macroeconomic environment in Brazil remains weak, expectations of a recovery have driven solid gains in BM&FBOVESPA along with the broader Brazilian equity market and currency. Shares have also benefited from the company's recent acquisition of Cetip, a provider of registration, custody, and settlement of fixed income securities, derivatives, and auto liens. The company has high barriers to entry due to its scale advantages, capital resources, and vertical integration into post-trading activities. We think BM&FBOVESPA will benefit from continued growth in trading volumes, bolstered by an improved competitive position from its acquisition of Cetip.

We also recently initiated a position in Chilean bank **Banco Santander-Chile**, in our view one of the best managed Latin American banks. We believe the bank will benefit from a market-friendly shift in political direction in Chile combined with the substantial recovery in commodity prices over the past year. Responding to the slowdown that ensued post commodity-boom, the bank adopted a conservative position, exiting high risk segments, preserving liquidity, being more selective on asset growth, and cutting costs. As a result, we think Banco Santander-Chile is well positioned to benefit as a new credit cycle emerges in the country.

Conclusion

We believe many international financial companies are poised to continue the outperformance we have witnessed since the beginning of the year, and we are actively researching new investment opportunities in the space. The international economic expansion, while previously lagging, is now clearly recovering and has begun to exceed domestic U.S. activity. The U.S. Federal Reserve, which raised rates earlier this year, has suggested there will likely be additional rate increases; and we are also seeing signs that central banks around the world are starting to shift their stance with regard to negative interest rates. We believe these trends bode well for the sector, though of course we will continue to monitor for risks to this view, including a sustained flattening of the yield curve or rates that slip deeper into negative territory. That said, we remain optimistic regarding the long-term potential for the high quality international financial companies in which we invest.

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The discussion of market trends and companies throughout this report are not intended as advice to any person regarding the advisability of investing in any particular security. Some of our comments are based on current management expectations and are considered "forward-looking statements." Actual future results, however, may prove to be different from our expectations. Our views are a reflection of our best judgment at the time of the publication of this report and are subject to change any time based on market and other conditions, and we have no obligation to update them. Investing in the stock market is always risky. Baron may not achieve its objective.

Portfolio holdings as a percentage of net assets as of March 31, 2017 for securities mentioned are as follows: **BNP Paribas S.A.** – Baron International Growth Fund (1.8%); **Julius Baer Group Ltd.** – Baron International Growth Fund (2.1%); **Shinhan Financial Group Co., Ltd.** – Baron Emerging Markets Fund (0.9%); **KB Financial Group Inc.** – Baron Emerging Markets Fund (1.1%); **Worldpay Group plc** – Baron International Growth Fund (1.1%); **Kotak Mahindra Bank Ltd.** – Baron Emerging Markets Fund (1.3%); **JM Financial Limited** – Baron International Growth Fund (0.8%); **Housing Development Finance Corporation Limited** – Baron Emerging Markets Fund (1.5%), Baron Global Advantage Fund (1.7%); **HDFC Bank Limited** – Baron Global Advantage Fund (1.0%); **Haitong Securities Co., Ltd.** – Baron International Growth Fund (1.0%), Baron Emerging Markets Fund (1.1%); **China Everbright Ltd.** – Baron Emerging Markets Fund (0.7%); **BM&FBOVESPA SA** – Baron International Growth Fund (0.5%), Baron Emerging Markets Fund (1.0%); **Banco Santander-Chile** – Baron Emerging Markets Fund (0.9%).

Portfolio holdings may change over time.

* % of Long Positions

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We offer thirteen mutual funds in retail, institutional, and R6 share classes, collective investment trusts, separately managed accounts, sub-advisory services and an offshore fund.

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