Baron Perspective

BARON FUNDS 1987

June 30, 2018

Active Strikes Back

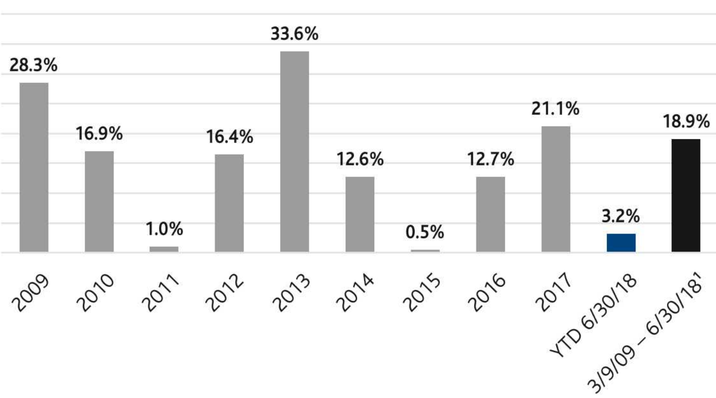
It is World Cup time and for soccer fans *nothing* is more important. Although the U.S. didn't get a chance to participate this year, our English friends across the pond have been interesting to watch. When the match against Colombia went to penalties, most English fans hung their heads, anticipating what was to come. England has a long history of losing on penalties. Since 1990, they have been eliminated on penalties six times in major tournaments during the knock-out stages. That's more than any other country. Their current coach, Gareth Southgate, missed the last penalty in a 1996 semi-final Euro match against Germany, which cost the game for England. But this year, just when English fans thought it was all over, Colombia missed their last two shots, and there it was – a win for England.

Similarly, just when active managers seemed to be in another losing match to their passive cousins, here it is – a win for active. After a winning streak by passive that caused commentators to declare an end to all things active, the play moved to the active side of the field. Game on. Let's take a look at what's happening.

While the U.S. equity market continues to advance for a 10th consecutive year, the recent rate of stock appreciation has slowed down relative to 2017. Since the beginning of the bull market, U.S. equities have appreciated at the remarkable annualized rate of 18.85% per year[1]. However, as the chart below shows, this result did not accumulate evenly over time – there were years with particularly strong performance and there were years barely in the black. Having this in mind, it is difficult to tell whether the recent slowdown is the last inning of the bull market or just a period of slower appreciation.

Equities Have Not Appreciated Evenly During the Bull Market

Russell 3000 Index Returns

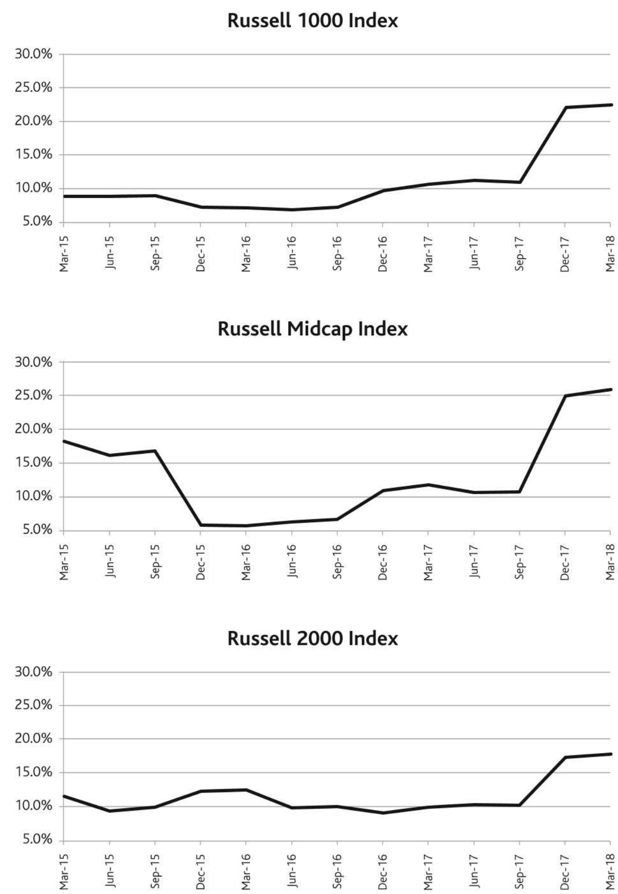


Source: FactSet.

Regardless of the direction of the market over the following months, we remain optimistic about equities. Solid economic data and strong company fundamentals give us confidence that companies are on firm footing and there is room for further growth. GDP has been growing at a solid pace for 102 months, unemployment is near record lows, and industrial activity has been improving[2], among others. While the stock market has increased only modestly in 2018, company earnings have been growing at the strongest pace in years, partly boosted by the tax reform.

Earnings Have Been Improving…

LTM EPS Growth Rates



Source: FactSet.

Calculation methodology: weighted-average, interquartiled.

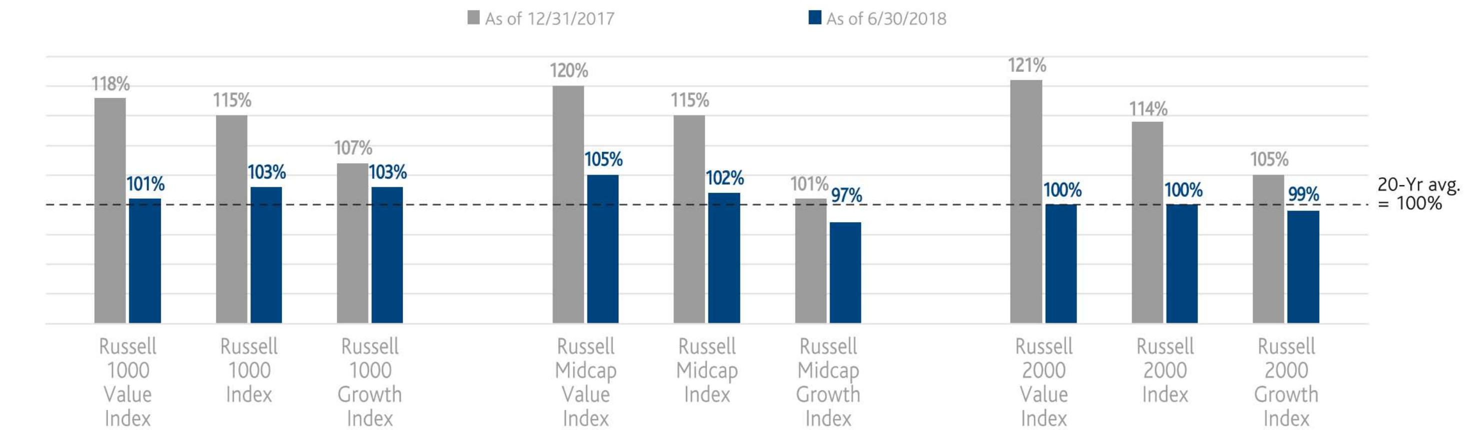
1 Annualized total return of the Russell 3000 Index from the beginning of the bull market on 3/9/2009 until 6/30/2018.

2 According to data compiled by the Federal Reserve Bank of St. Louis.

Stock valuations have declined amidst stronger earnings growth and are currently in line with historical averages, as shown in the chart below. For example, as of 12/31/2017, the P/E of the Russell 2000 Growth Index was 5% above the 20-year historical average, and by 6/30/2018, it declined to 1% below the historical average.

...And Valuations Are In Line With Historical Averages

Current P/Es as a % of 20-Year Average P/Es

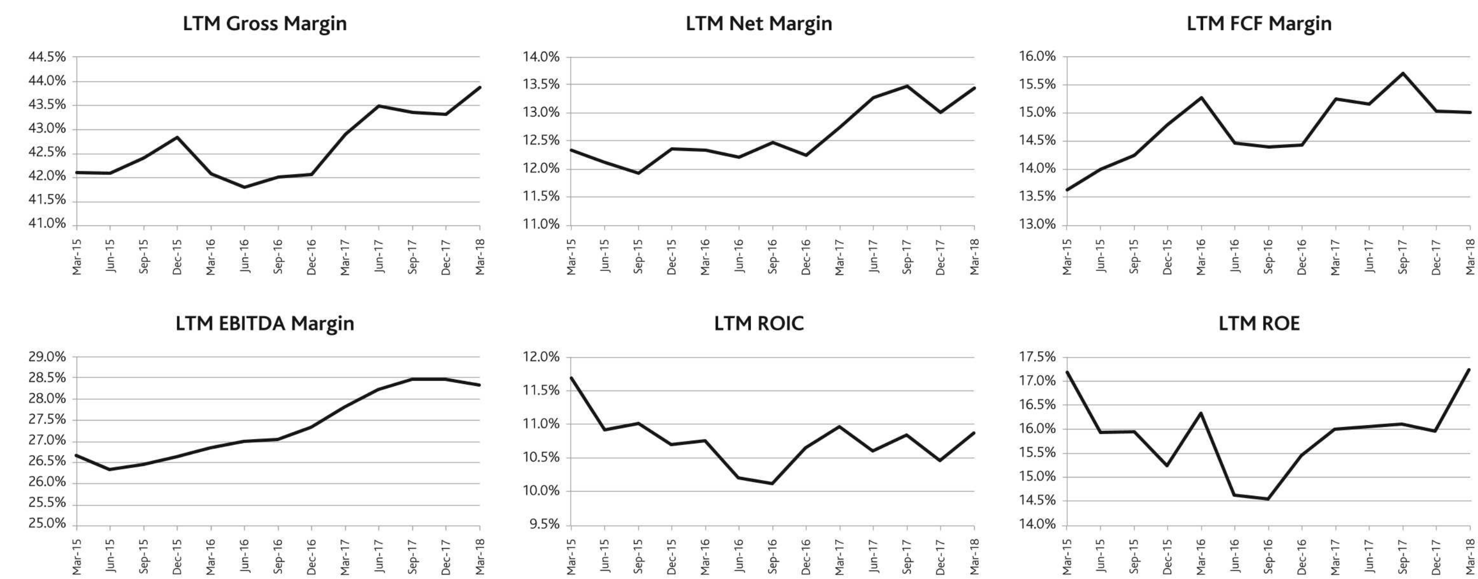


Sources: The Bank of New York Mellon Corporation, Baron Capital.

Other key fundamental company indicators like gross margin, net margin, free cash flow margin, return on invested capital, and return on equity have also improved or remained at solid levels. Analyst projections for business revenues and earnings are also favorable across all sectors.

U.S. Equity Fundamentals Are Solid

Russell 3000 Index – Fundamental Characteristics



Source: FactSet.

Calculation methodology: weighted-average, interquartiled.

Surely, not everything is rosy; there are areas with weak spots in both the economy and the stock market. But we think there is nothing majorly worrisome standing out and, fundamentally, things look fine. It seems that if the stock market declines tomorrow, it will not be because businesses are doing poorly but rather because of external factors like political tensions or a change in sentiment.

Despite the positive economic and company results, in 2018, the market has become more unpredictable and has been struggling to find direction. Political uncertainty, tariffs and trade war tensions, the Fed's fiscal policy, and fears of rising inflation and an overheating economy have been driving some of the confusion and volatility. The higher uncertainty has left investors wondering what the right move is. At the same time, investors have continued to exit from active equity funds and crowd into passive products. In the first half of 2018 actively managed U.S. equity mutual funds saw a combined net outflow of more than $100 billion, while index funds and ETFs had net inflows of $80 billion[3].

In our opinion, skilled research analysts and portfolio managers can add significant value in environments of uncertainty compared to indexed products. We have remarked before that broad market indexes do not discern between companies with good and weak fundamentals, cannot evaluate forward business implications arising from economic or policy changes, and do not have the flexibility to adjust the portfolio like active managers do. A strong rising market may be forgiving of indiscriminate investment choices, but a more volatile one is likely to penalize such behavior. Yet, it seems that few investors are giving this thought serious consideration.

March 2014 was the last month when active equity funds, as a group, had positive net flows[3]. Over the following 51 months, a net cumulative of $800+ billion has been redeemed from active products. After a period of disappointing relative performance of active, particularly in 2014 and 2016, a vast number of investors lost patience and conviction and switched to passive. Others followed, giving in to common investor biases like herd behavior and performance chasing. There were also those who, quite prematurely, pronounced the permanent demise of active management and completely wrote it off.

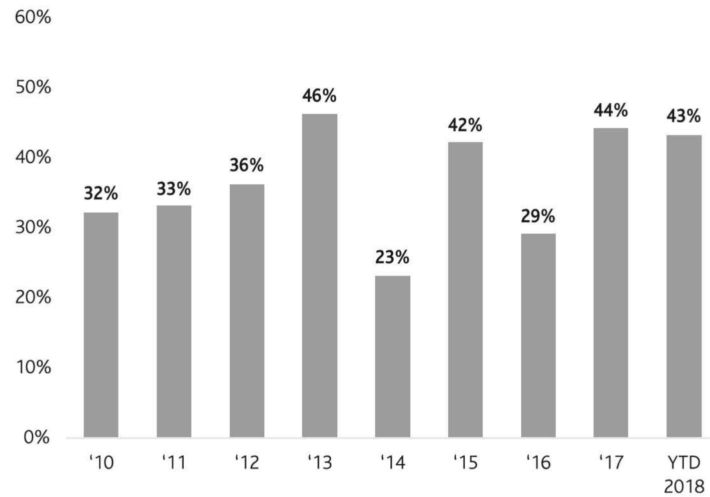
To be a successful active investor, we believe it is important to have a good understanding and the right expectations about active products. Active will be around for a long time – there will always be someone who wants to beat the market and will try. However, it is important to keep a few things in mind:

- Beating the market is not easy and only some active managers will succeed at it. Thus, it would be wrong to assume that there is no value in active when/because most active managers are underperforming.
- Like most things in economics and finance, the performance of active managers tends to be cyclical and goes through good and bad periods.
- No active manager will outperform 100% of the time (and no index fund is expected to outperform its benchmark).
- Few active managers are skilled enough to beat their benchmark with high consistency. The ones that do can deliver long-term value and above-average returns to investors.
- Patience and a long-term investment horizon are key for good results. Just like switching lanes does not help you beat traffic[4], constantly switching between funds is unlikely to help you beat the market.

After a tough 2016, active managers have been performing significantly better. As shown in the chart below, 44% outperformed their respective Morningstar category benchmark in 2017 and 43% did so in the first half of 2018. It is worth mentioning that this data has not been scrubbed for closet indexers (passive managers who claim to be active), which is likely understating the outperformance rate of the truly active funds.

The Performance of Active Managers Is Improving

% of Active Funds Outperforming*



Source: Morningstar Direct, Baron Capital.

** The calculation includes all share classes of non-index mutual funds with available returns in Morningstar's US Fund Large Growth, US Fund Large Value, US Fund Large Blend, US Fund Mid-Cap Growth, US Fund Mid-Cap Value, US Fund Mid-Cap Blend, US Fund Small Growth, US Fund Small Value, and US Fund Small Blend categories. Each share class's performance is measured versus the respective Morningstar category benchmark.*

According to Bank of America Merrill Lynch, overexposure to the strongly performing technology and consumer discretionary sectors has likely contributed to good fund performance[5]. As growth stocks outperformed value, the managers with a growth tilt also fared better.

The charts on the next page show the results of active managers within each category over the past 18 months. During this period, more than half of small and mid-cap active growth managers outperformed their respective category benchmarks, a higher proportion compared to their active value and blend counterparts. Furthermore, the outperforming small and mid-cap funds delivered outstanding average excess returns of 11.0% and 9.1%, respectively, significantly above the excess returns in the value and blend categories. Large-cap growth managers had a bigger hurdle to overcome, as their category index rose the highest over the period. Nevertheless, 43% of them outperformed, delivering an average excess return of 8.7%. Large-cap value funds had an unusually high outperformance rate, although their absolute and relative returns were lower than growth funds, on average.

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3 According to data from Morningstar as of 7/11/2018.

4 Actually, research has shown that as drivers increasingly switch lanes, traffic jams get worse.

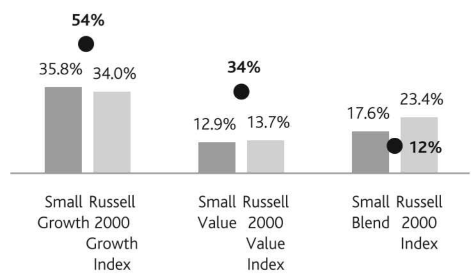
5 See Bank of America Merrill Lynch's *U.S. Mutual Fund Performance Update* from 5/2/2018.

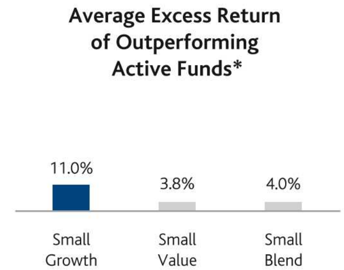
Growth Managers Have Performed Well

Active Manager Scorecard

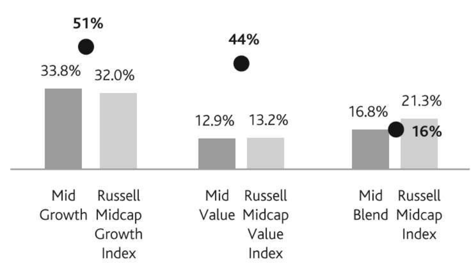
12/31/2016 – 6/30/2018

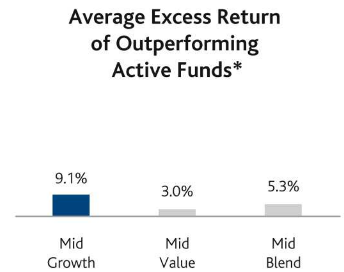
Small-Cap:



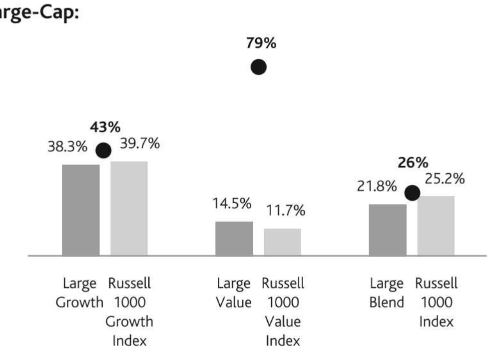


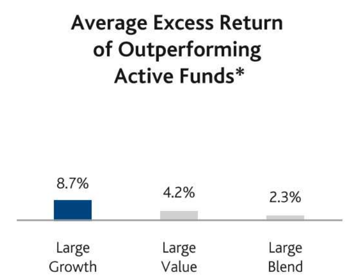
Mid-Cap:





Large-Cap:





■ Average Active Fund Return ■ Category Index Return
● % Active Funds Outperforming

Source: Morningstar Direct, Baron Capital.

* The Average Excess Return of Outperforming Active Funds represents the simple average of the excess returns of all non-index mutual fund share classes in each category that outperformed their respective category benchmark during the period. The calculations are for the following Morningstar categories: US Fund Small Growth, US Fund Small Value, US Fund Small Blend, US Fund Mid-Cap Growth, US Fund Mid-Cap Value, US Fund Mid-Cap Blend, US Fund Large Growth, US Fund Large Value, and US Fund Large Blend.

In 2016, nearly $150 billion[6] left active growth managers, missing out on these outstanding returns over the next year and a half. What is more baffling is that, as the score card of active and active growth improved noticeably in 2017 and 2018, investors have not been impressed and continued taking money out, leaving additional excess return on the table. While we cannot quite understand the rationale behind this investor behavior, we remain hopeful that sooner rather than later more investors will recognize the potential benefits of active management.

The past 18 months have been great for the Baron Funds, too. Nine of our ten domestic funds[7] outperformed their primary benchmarks. Four delivered cumulative excess returns of more than 20%, while the other five beat the benchmark by at least 5.5%. While favorable exposures to well-performing areas, like Information Technology and Consumer Discretionary, helped performance, our excess returns were largely driven by positive stock selection, as shown below.

6 According to data from Morningstar as of 7/11/2018.

7 Only the U.S. equity Baron Funds with a track record over the entire period 12/31/2016 – 6/30/2018.

Stock Selection Has Been the Driver of Baron's Outperformance

Performance of the U.S. Equity Baron Funds

Fund Name	Primary Benchmark	12/31/2016 – 6/30/2018: Cumulative Fund Return	Cumulative Benchmark Return	Cumulative Fund Excess Return	Excess Return From Stock Selection	Annualized Fund Performance as of 6/30/2018: One Year	Three Years	Five Years	Ten Years	Since Inception
Baron Growth Fund	Russell 2000 Growth Index	40.96%	34.01%	6.95%	12.40%	20.38%	11.54%	12.55%	10.71%	13.36%
Baron Small Cap Fund	Russell 2000 Growth Index	39.61%	34.01%	5.60%	10.38%	20.48%	11.91%	12.43%	11.01%	10.40%
Baron Discovery Fund	Russell 2000 Growth Index	56.69%	34.01%	22.68%	22.92%	25.69%	15.80%			17.66%
Baron Asset Fund	Russell Midcap Growth Index	40.04%	32.03%	8.01%	5.18%	18.01%	12.74%	14.69%	10.70%	11.69%
Baron Opportunity Fund	Russell 3000 Growth Index	69.45%	39.23%	30.22%	22.38%	32.07%	15.27%	14.44%	11.74%	7.05%
Baron Focused Growth Fund	Russell 2500 Growth Index	44.22%	34.46%	9.76%	14.24%	20.71%	10.11%	11.11%	9.05%	11.43%
Baron Partners Fund	Russell Midcap Growth Index	52.36%	32.03%	20.33%	12.35%	18.46%	13.51%	15.96%	11.55%	13.29%
Baron Fifth Avenue Fund	Russell 1000 Growth Index	62.30%	39.66%	22.64%	18.49%	29.81%	16.04%	18.47%	11.89%	9.55%
Baron Energy & Resources Fund	S&P North American Natural Resources Sector Index	–3.29%	6.58%	–9.87%	–2.53%	12.23%	–5.98%	–2.56%		–1.92%
Baron Real Estate Fund	MSCI USA IMI Extended Real Estate Index	25.81%	17.19%	8.62%	3.07%	8.69%	5.46%	9.96%		14.75%

Sources: FactSet, Baron Capital.

Notes: Each Fund's returns are represented by the Institutional Share class. Excess returns are versus each Fund's primary prospectus benchmark and are net of fees. Return From Stock Selection was calculated using the Brinson performance attribution method and is a combination of selection and interaction effects. Brinson attribution is a form of relative performance attribution and was introduced to the investment industry in 1985, known as Brinson, Hood, Beebower (BHB). The BHB framework evaluates excess performance based on the manager's decision making process. A portfolio manager that has discretion as to which sectors to invest in and which assets within those sectors to buy can be evaluated as to how well he or she executes those decisions. Which sectors to invest in are known as allocation decisions. Which assets to buy are known as selection decisions.

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.

Annual expense Ratios for Inst. shares as of 9/30/2017: Baron Asset Fund, 1.04%, Baron Growth Fund, 1.04%, Baron Small Cap Fund, 1.05%, Baron Opportunity Fund, 1.14%, Baron Fifth Avenue Growth Fund, 0.84%, but the net annual expense ratio was 0.75% (restated to reflect current fee waivers), Baron Discovery Fund, 1.23%, but the net annual expense ratio was 1.10% (net of the Adviser's fee waivers). Annual expense Ratios for Inst. shares as of 12/31/2017: Baron Partners Fund, 1.53% (comprised of operating expense of 1.08% and interest expense of 0.45%), Baron Focused Growth Fund, 1.12%, but the net expense ratio was 1.10% (net of the Advisor's fee waivers), Baron International Growth Fund, 1.13%, but the net annual expense ratio was 0.95% (restated to reflect management fee reduction from 1.00% to 0.88% and current expense fee waivers), Baron Real Estate Fund, 1.06%, Baron Emerging Markets Fund's annual expense ratio for the Institutional Shares as of December 31, 2017 was 1.10%, Baron Energy and Resources Fund, 1.42%, but the net annual expense ratio was 1.10% (net of the Adviser's fee waivers), Baron Global Advantage Fund, 1.59%, but the net annual expense ratio was 0.90% (restated to reflect management fee reduction from 1.00% to 0.85% and current expense fee waivers).

Baron's portfolio managers do not invest by making short-term sector and industry bets. Instead, we focus on investing in areas with secular growth opportunities. Within these areas, we look for companies with strong competitive advantages, exceptional managements, and attractive valuations, among other factors.

While we are satisfied with the performance of our Funds over the past 18 months, our focus remains on the long term. Our portfolios have benefitted from a long-term investment approach, and we believe that investors in mutual funds will also benefit from it. In previous letters, we have discussed the negative implications of investors' short-termism and tendency to time markets and managers, largely driven by behavioral biases.

A recent article in *The Wall Street Journal* entitled "Don't Just Dive Into Action: Stop To Think First" talked about the benefit of goalkeepers staying put during a penalty kick. According to the article, goalkeepers have a higher chance of saving a penalty shot if they do not jump to the sides but rather stay in the center of the goal. Yet, they don't due to action bias – an urge to do something rather than nothing, frequently out of fear of regret. In our opinion, many investors suffer from the same bias, which ends up being costly, and the continued outflows from active products, and inflows into passive, are an example. As with goalkeepers, we believe that the best strategy for investors is to stay put. Invest for the long term.

Linda S. Martinson
President and COO

Investors should consider the investment objectives, risks, and charges and expenses of the investment carefully before investing. The prospectus and summary prospectuses contain this and other information about the Funds. You may obtain them from the Funds' distributor, Baron Capital, Inc., by calling 1-800-99BARON or visiting www.BaronFunds.com. Please read them carefully before investing.

The discussion of market trends and companies 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 and are subject to change any time based on market and other conditions, and we have no obligation to update them.

Risks: The Funds invest primarily in equity securities, which are subject to price fluctuations in the stock market. Securities of small and medium-sized companies may be thinly traded and more difficult to sell. Specific risks associated with non-diversification and leverage include increased volatility of the Fund's returns and exposure of the Fund to greater risk of loss in any given period. Non-diversified funds may experience greater volatility and risk of loss in any given period. Companies propelled by innovation, including technology advances and new business models, may present the risk of rapid change and product obsolescence, and their success may be difficult to predict for the long term. Energy companies can be affected by fluctuations in energy prices and supply and demand of energy fuels. Resources industries can be affected by international political and economic developments, the success of exploration projects, and meteorological events.

The **excess return from stock selection** appearing in the table on page 5 measures the aggregate result of the portfolio manager's ability to select securities within each of the GICS sectors relative to their benchmarks. The over or underperformance of the portfolio within each sectors is weighted by the benchmark sector weight, therefore, selection is not affected by the manager's allocation to the sector. The weight of the sector in the benchmark determines the size of the effect – the larger the sector, the larger the effect is, positive or negative. Selection effect is calculated as follows: [(benchmark weight)] * [(portfolio return) – (benchmark return)].

For a full description of the **Brinson attribution method**, please refer to Brinson, Gary P., L. Randolph Hood, and Gilbert L. Beebower, "Determinants of Portfolio Performance," Financial Analysts Journal, July-August 1986, pp. 39-44.

Russell 3000® Index measures the performance of the broad segment of the U.S. equity universe comprised of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market. **Russell 2000® Index** measures the performance of small-sized U.S. companies. Russell 1000® Index measures the performance of large-sized U.S. companies. **Russell Midcap® Index** measures the performance of medium-sized U.S. companies. Index performance is not fund performance. Investors cannot invest directly in an index.

Price/Earnings Ratio (trailing 12-months) is a valuation ratio of a company's current share price compared to its actual earnings per share over the last twelve months. **Earnings per share growth** is defined as the percentage change in normalized earnings per share over the previous 12-month period to the latest year end. It gives a good picture of the rate at which a company has grown its profitability.

BAMCO, Inc. is an investment adviser registered with the U.S. Securities and Exchange Commission (SEC). Baron Capital, Inc. is a broker-dealer registered with the SEC and member of the Financial Industry Regulatory Authority, Inc. (FINRA).

The Morningstar category benchmarks are as follows:
For the US Fund Large Growth: Russell 1000 Growth Index. For the US Fund Large Value: Russell 1000 Value Index. For the US Fund Large Blend: Russell 1000 Index. For the US Fund Mid-Cap Growth: Russell Midcap Growth Index. For the US Fund Mid-Cap Value: Russell Midcap Value Index. For the US Fund Mid-Cap Blend: Russell Midcap Index. For the US Fund Small Growth: Russell 2000 Growth Index. For the US Fund Small Value: Russell 2000 Value Index. For the US Fund Small Blend: Russell 2000 Index.

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Non-mutual fund products are available to institutional investors only.

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

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- BARON FOCUSED GROWTH STRATEGY
- BARON SMALL TO MID CAP GROWTH STRATEGY
- BARON MID CAP GROWTH STRATEGY
- BARON DURABLE ADVANTAGE STRATEGY
- BARON LARGE CAP GROWTH STRATEGY
- BARON ALL CAP GROWTH STRATEGY
- BARON HIGH GROWTH STRATEGY
- BARON EMERGING MARKETS STRATEGY
- BARON GLOBAL ADVANTAGE STRATEGY
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- BARON REAL ESTATE STRATEGY
- BARON REAL ESTATE INCOME STRATEGY

MUTUAL FUNDS

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