BARON CAPITAL

Baron Perspective

December 31, 2016

Don't Get Bitten by Biases

2016 was an unusual year. The Cubs won the World Series, Leicester City F.C. won the English Premiership and Ryan Lochte vandalized a gas station bathroom.

In the investment world, one of the things that made the strongest impression on us was investor behavior. Investors seem scattered, going after every shiny object rather than heading in a purposeful direction. All the craze and uncertainty created by the very unusual U.S. Presidential election, tepid economic growth, Fed monetary policy, health care reforms, Brexit and China's economic well-being, among others, only added confusion and anxiety. Concerns about the prolonged equity bull market also shifted investor attention away from important fundamentals. Instead, chasing momentum and short-termism seem to have become the new normal.

Investors have been pulling their money from actively managed equity funds and pouring it into passive vehicles that are designed to be no better than average. Money is also going into taxable bond funds in a desperate search for yield without regard to risk. Companies are leveraging up to pay dividends or repurchase shares, to take advantage of low interest rates and to appeal to investors' quest for yield. All of this seems irrational to us.

Irrational investor behavior is driven by emotion rather than rational thinking. It is neither new nor uncommon. Humans are wired to make choices that will help us avoid regretting our decisions and achieve happiness. Often these choices are not driven by reason. For example, everyone knows not to go to the supermarket when you are hungry. You will end up with way more carbs in your cart than you intended, and you will surely regret it later.

In the world of investing such behavior can be costly. A recent study by Dalbar, a financial services market research firm, showed that investor behavior is the primary cause for investor underperformance over the past 20 years. The study estimated that the typical investor's trading behavior, which includes panic selling, excessively exuberant buying, and attempts at market timing, has cost investors, in the aggregate, $122 billion.

Investor Behavior Has Been the Biggest Cause for Underperformance

Major Causes of Equity Investor Underperformance

1995 - 2015

Cause	% Contributed to Underperformance	Underperformance Amount
Lack of Availability of Cash to Invest*	0.54%	$44 Bn
Need for Cash (planned & unplanned)**	0.68%	$55 Bn
Fund Expenses (incl. management fees)	0.79%	$65 Bn
Voluntary Investor Behavior Underperformance* **	**1.50%**	**$122 Bn**
TOTAL	**3.52%**	**$286 Bn**

Source: "Quantitative Analysis of Investor Behavior, 2015" DALBAR, Inc. www.dalbar.com

** Lack of availability of cash represents the investor return that is lost by delaying the investment.*

*** Need for cash represents the percentage of investor return that is lost or gained by withdrawing the investment before the end of the period being measured.*

**** Voluntary investor behavior generally represents panic selling, excessively exuberant buying and attempts at market timing.*

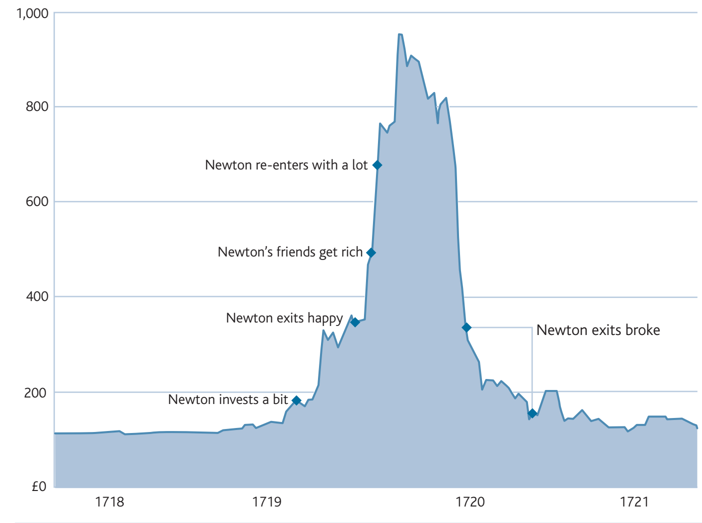
Biases Bite

Investing seems fairly simple. Buy low and sell high. That is easier said than done. You establish financial goals, figure out how to achieve them, and follow your process. Unfortunately, most investors lack the strong discipline and patience needed and sooner or later fall victim to emotional behavior.

It doesn't matter how smart or educated they are. Even one of the greatest minds, Isaac Newton, gave in to his emotions. In 1720, he was an early investor in the South Sea Company, which had a monopoly on trade in the South Seas. After the stock more than doubled, Newton decided to lock in his profit and sold. Yet the stock continued to rise, and he couldn't resist remaining on the sidelines while his friends were getting richer. Greed and envy prevailed. Newton purchased shares again, but this time at more than three times his original price.

Unfortunately for Newton, the stock crashed a few months later, and he lost almost all of his savings, the equivalent of about $4 million at today's value. With this, he re-discovered the force of gravity, this time in investing. As the story goes, he conceded, "I can calculate the movement of the stars, but not the madness of men." One of the smartest men of all time, the man who invented calculus and the three laws of motion, fell victim to irrational behavior.

Isaac Newton and the South Sea Bubble



Source: MARC FABBER, GLOOM BOOM DOOM

Irrational decisions are the result of biases that make us think and act in certain ways. In Newton's case, his biggest bias was regret aversion. Simply put, regret aversion is when people fear they will regret a choice they have made and that regret influences subsequent actions.

Because biases affect our decision making, the more aware we are of them, the better we will be at making decisions. In economics, there is an entire field dedicated to analyzing investor behavior known as behavioral finance. There are dozens of well-documented biases. Some of the most widely recognized include:

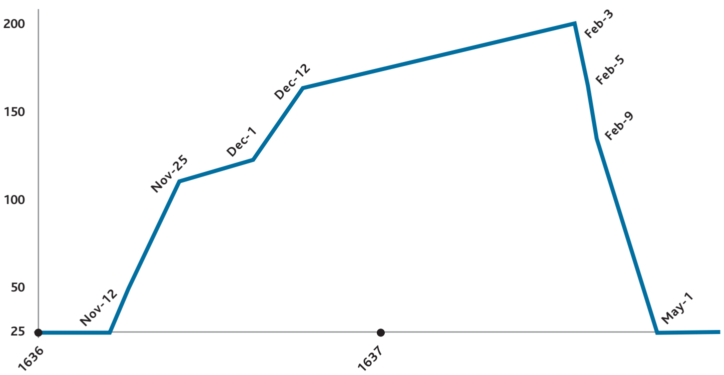
1. confirmation bias: focusing on information that validates our own opinions and ignoring information that doesn't
2. recency bias: drawing inferences about the future based only on the recent past
3. familiarity bias: investing in securities that are familiar
4. gambler's fallacy: making decisions based on perceived patterns. An example of gambler's fallacy is believing that heads is more likely after a string of tails on a coin flip. It is totally irrational because each coin flip is completely unrelated to the prior outcome.

One of the most common biases is herd behavior, where people blindly follow the actions of others rather than make independent decisions.

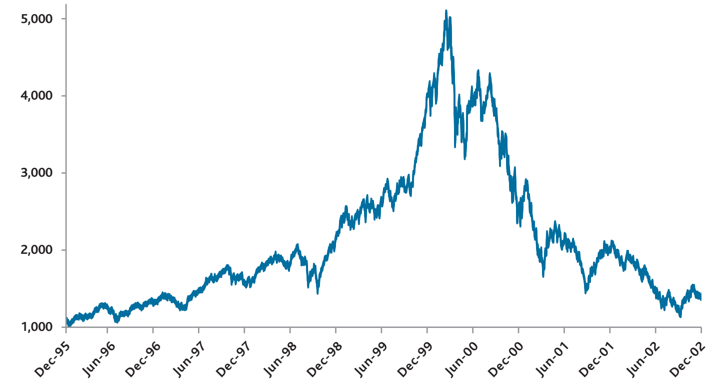
A particularly colorful example of herd behavior is Tulip Mania. Tulips were introduced to the Dutch in the early 1600s. Initially, the flowers attracted attention for their beauty. As word spread and their popularity grew, tulips were increasingly coveted, and their prices rose rapidly. Soon enough, people from all trades and classes were mesmerized by the tulip frenzy. Seeing an opportunity, speculators then entered the fray. Prices rose beyond reason and at a certain point, ten tulip bulbs cost the equivalent of a nice townhouse. When the prices became too high for the speculators to continue, the tulip market quickly fell apart, and people were ruined. They were beguiled into a mindless obsession that resulted in financial disaster.

Investors Have Not Changed from the 1600s… to the 2000s

Tulip price index 1636-37



NASDAQ Composite Index 1995-2002



Source: FactSet

As a more recent example of herd behavior, some of you might remember the dot-com bubble. As with the tulips, people couldn't buy enough technology stocks, which were the fad of the moment. Many recklessly invested in tech stocks like Pets.com, Webvan, and eToys.com without considering their valuations, the sustainability of the businesses, or whether there was a viable market for the product. We didn't.

At the time we believed that rapidly changing technology businesses didn't meet our investment criteria – sustainable competitive advantages, in particular. We believed that the technology frenzy had caused unjustified market valuations that, as Ron wrote at the time, "…could only be justified by heroic assumptions about future profit growth." While the performance of our Funds suffered during this technology stock mania, we were well situated when the bubble burst in March of 2000. The Table on the following page shows how our Funds performed versus their benchmarks during the rally, after the bubble burst, and over the entire cycle.

Baron Funds and the Technology Boom and Bust

Baron Funds vs. Benchmarks Cumulative Returns

From 10/08/1998 to 9/21/2001

Baron Fund	Baron Fund Benchmark	Market Stages/ Cycles*	Start Date	End Date	Length (months)	Baron Fund Cumulative Return	Benchmark Cumulative Performance	Excess Return
Baron Growth Fund	Russell 2000 Growth Index	Bull	10/8/1998	3/9/2000	17	108.15%	183.51%	–75.36%
		Bear	3/9/2000	9/21/2001	18	–15.87%	–59.98%	44.11%
		Full Cycle	**10/8/1998**	**9/21/2001**	**35**	**75.12%**	**13.45%**	**61.67%**
Baron Small Cap Fund	Russell 2000 Growth Index	Bull	10/8/1998	3/9/2000	17	171.26%	183.51%	–12.25%
		Bear	3/9/2000	9/21/2001	18	–32.41%	–59.98%	27.57%
		Full Cycle	**10/8/1998**	**9/21/2001**	**35**	**83.34%**	**13.45%**	**69.89%**
Baron Asset Fund	Russell MidCap Growth Index	Bull	10/8/1998	9/4/2000	23	89.11%	172.31%	–83.20%
		Bear	9/4/2000	9/21/2001	13	–37.32%	–56.62%	19.30%
		Full Cycle	**10/8/1998**	**9/21/2001**	**35**	**18.53%**	**18.12%**	**0.41%**

Source: Baron Capital

** A Bull Market is a sustained period of positive market returns where the index reaches the highest value prior to a decline of at least 20%. A Bear Market is a sustained period of negative market returns where the index reaches a decline of at least 20% from a previous market peak. Full Market Cycles include a Bear Market preceded by a Bull Market. Market cycle periods may vary for different asset classes. The indexes used to determine the start and end date for small cap and midcap stocks were the Russell 2000 Index and the Russell MidCap Index, respectively.*

Baron Growth Fund's annualized returns as of December 31, 2016: 1-year, 6.31%; 5-years, 11.56%; 10-years, 6.63%; Since Inception (12/30/1994), 12.56%. Annual expense ratio for the Institutional Shares as of September 30, 2016 was 1.05%. Baron Small Cap Fund's annualized returns as of December 31, 2016: 1-year, 10.26%; 5-years, 11.77%; 10-years, 6.77%, Since Inception (9/30/1997), 9.34%. Annual expense ratio for the Institutional Shares as of September 30, 2016 was 1.06%. Baron Asset Fund's annualized returns as of December 31, 2016: 1-year, 6.51%; 5-years, 13.53%; 10 years, 6.75%; Since Inception (6/12/1987), 11.05%. Annual expense ratio for the Institutional Shares was 1.04%.

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. 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.

* Please see back of letter for Average Investor and Fund definitions.

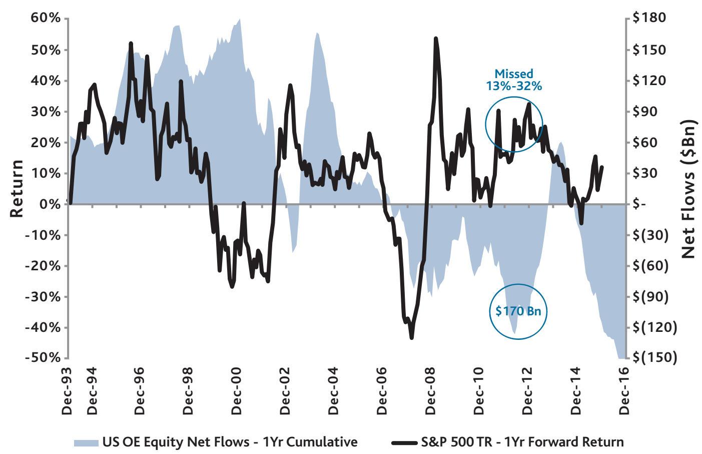
Biases Bite Mutual Fund Investors Too

Emotionally-driven investment decisions tend to yield disappointing results. The basic tenent of investing gets turned on its head, and people end up buying high and selling low. No one gets it right all the time, but making that mistake on a regular basis is not a particularly profitable investment strategy. Yet that is what we see equity investors doing.

In the chart below, the blue represents equity mutual fund flows and the black line is the return of the S&P 500 a year later. The data shows that stock fund inflows were strongest just before the market declined, and outflows were strongest just before the market rallied. For example, between August 2011 and December of 2012, around $170 billion left U.S. equity mutual funds, and thus missed earning between 13% and 32% over the following 12 months. And we see a similar trend happening again.

Investor Anxiety Leads to Buy High/Sell Low Behavior

Equity Mutual Fund Flows vs. One-Year Forward Returns



Source: Baron Capital using Morningstar Data. Flows include obsolete funds.

This investor behavior results in consistent underperformance. Since the majority of mutual fund investors don't stay invested for the long term, the returns experienced by the average investor are often lower than the returns achieved by the funds.

The Average Investor Performs Worse Than The Average Fund*

Average Investor vs. Average Fund

10-Yr Annualized Return Difference as of 12/31/2016

	Value	Blend	Growth
Large	-2.2%	-1.5%	-1.3%
Mid	-2.0%	-1.1%	-1.9%
Small	-1.4%	-2.1%	-2.0%

Source: Morningstar Direct

Exceptional Takes Time

The biggest difference between successful and unsuccessful investors is rational behavior. As noted investor Benjamin Graham said, "People don't need extraordinary insight or intelligence. What they need most is the character to adopt simple rules and stick to them." We agree: discipline and patience are key to achieving exceptional results in anything you do.

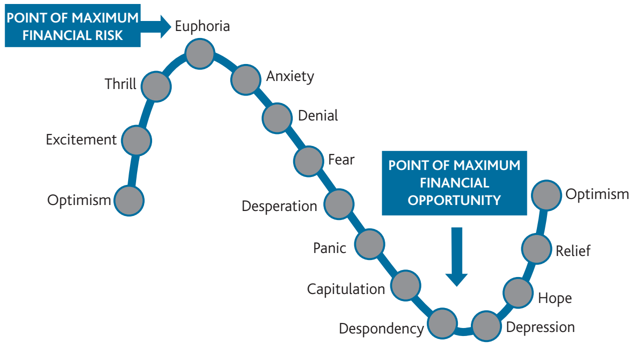
Think of a young athlete who aspires to be an NFL quarterback. He will practice throwing the football through a tire thousands of times to improve his accuracy. He will get his sisters and all his friends to catch the ball while he practices perfecting his spiral and throwing the ball far down the field. If he is disciplined and patient, and develops outstanding skills, perhaps he will advance to be the starting quarterback on his high school and college teams, and then ultimately be drafted to the NFL.

It takes time to become exceptionally good. Few investors realize how important this is. Instead, they focus on the short term, listen to market noise, and seek out schemes for quick profits. As a result, they make irrational decisions.

We currently see a great deal of irrational behavior in the markets. The market and investor emotions fluctuate in tandem.

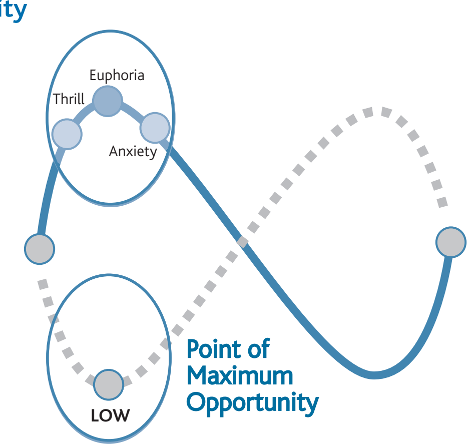
As the stock market rises, investor optimism builds to euphoria, only to come crashing down through anxiety, fear, panic, and, eventually, despondency. It then builds again, through hope and renewed optimism, getting back to where we started.

The Stock Market and the Cycle of Emotional Investing



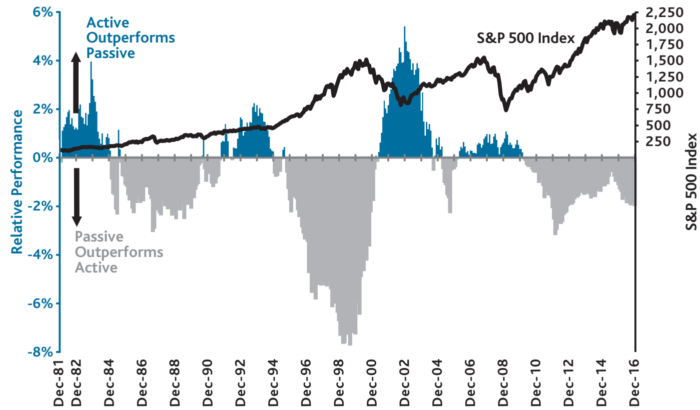
We believe that the stock market and investor emotions are currently around their high point. On the other hand, we think active management is at the point of maximum financial opportunity.

Active Management Is at the Point of Maximum Financial Opportunity



Here is why. The performance of the markets is cyclical, and so is the performance of active and passive products. The average active manager tends to perform better during gradual uptrends and down markets – and tends to lag when the market is spiking high.

The Performance of Active and Passive Managers Has Been Cyclical



Source: Morningstar Direct, Baron Capital

The analysis is based on monthly rolling 3-year returns for the period 12/31/1981 to 12/30/2016.

US OE Large includes all share classes in Morningstar's US OE Large Growth, US OE Large Value and US OE Large Blend categories. The performance of passive funds is calculated as the average 3-year performance of all index fund share classes. The performance of active funds is calculated as the average 3-year performance of all non-index fund share classes.

For nearly eight years we have been through one of the strongest bull markets in history. As a result, passive has attracted a lot of attention – and assets.

We believe that many investors who are switching from active to passive are victims of biases. Some are swayed by recent performance, some are just doing what others do, some are trying to time the market. Perhaps, because they face so many options, investors choose a simple solution – passive. Although passive offers certainty, you pay a big price. What you get is mediocrity: average returns.

Disciplined and patient long-term active managers like Baron can capitalize on market inefficiencies and balance investor irrationality to achieve exceptional results. Those who try to time market swings or make quick profits eventually make the same mistakes, in our opinion, as Newton, the Dutch tulip people, and the dot com investors. Plus the millions of others who buy high and sell low.

Don't make that mistake. Be patient. Exceptional takes time.

Linda S. Martinson
President and COO

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The **Average Investor** is represented by the Morningstar® Investor Return™. The Morningstar® Investor Return™ (also known as dollar-weighted return) measures how the average investor fared in a fund over a period of time. Investor return incorporates the impact of cash inflows and outflows from purchases and sales and the growth in fund assets. In contrast to total returns, investor returns account for all cash flows into and out of the fund to measure how the average investor performed over time. Investor return is calculated in a similar manner as internal rate of return. Investor return measures the compound growth rate in the value of all dollars invested in the fund over the evaluation period. Investor return is the growth rate that will link the beginning total net assets plus all intermediate cash flows to the ending total net assets.

The **Average Fund** is represented by Morningstar's category average returns for Morningstar US OE Small Growth, Morningstar US OE Small Blend, Morningstar US OE Small Value, Morningstar US OE Mid-Cap Growth, Morningstar US OE Mid-Cap Blend, Morningstar US OE Mid-Cap Value, Morningstar US OE Large Growth, Morningstar US OE Large Blend and Morningstar US OE Large Value. Morningstar's category average returns are not weighted and represent the straight average of annualized returns of each of the funds in the Categories.

Morningstar classifies funds as being large-cap, mid-cap, or small-cap based on the market capitalization of the fund's stock holdings; and as value, blend, or growth based on the value-growth orientation of the stock holdings. The nine possible combinations of these characteristics correspond to the nine squares of the Morningstar Style Box – size is displayed along the vertical axis and style is displayed along the horizontal axis.

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BARON SMALL CAP GROWTH STRATEGY
BARON SMALL TO MID CAP GROWTH STRATEGY

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