

## DEAR BARON EMERGING MARKETS FUND SHAREHOLDER:

## PERFORMANCE

Baron Emerging Markets Fund (the "Fund") advanced 6.16% (Institutional Shares) for the fourth quarter of 2017, and 40.63% for the full year, while its principal benchmark index, the MSCI EM Index, gained 7.44% for the fourth quarter and 37.28% for the calendar year. Emerging market ("EM") equities led global markets throughout a strong year powered by healthy economic growth, strong earnings, and favorable policy support. In addition, elections and political risks were resolved favorably during the latter months of the year in countries such as India, Brazil, Chile, Argentina, and South Africa, helping fuel confidence and valuation support. Looking forward, we believe the recent outperformance by EM and other international equities may be in the early innings as many countries are introducing productivity-enhancing reforms, and political winds have shifted in a market-friendly direction. Further, we are quite intrigued by an explicit goal in China to gain market and profit share from Western multinationals in high value-added sectors, which we believe could broadly benefit EM corporate earnings, particularly relative to major global multinationals that represent a significant presence in the developed world indexes. We are pleased with our year-to-date absolute and relative performance, particularly considering our below market beta, which tends to support our relative performance in more challenging market conditions. We remain optimistic that our differentiated discipline and process position us well over the long term to take advantage of substantial investment opportunities across our broad universe.

Table I.  
Performance

Annualized for periods ended December 31, 2017

	Baron Emerging Markets Fund Retail Shares <sup>1,2</sup>	Baron Emerging Markets Fund Institutional Shares <sup>1,2</sup>	MSCI EM Index <sup>1</sup>	MSCI EM IMI Growth Index <sup>1</sup>
Three Months <sup>3</sup>	6.09%	6.16%	7.44%	8.17%
One Year	40.34%	40.63%	37.28%	44.70%
Three Years	8.96%	9.23%	9.10%	11.08%
Five Years	8.95%	9.23%	4.35%	6.49%
Since Inception (December 31, 2010)	6.59%	6.85%	2.56%	4.07%

For the fourth quarter of 2017, while we underperformed the MSCI EM Index, we were comfortable with our performance in a strong market. For the full

Performance listed in the above table is net of annual operating expenses. Annual expense ratio for the Retail Shares and Institutional Shares as of December 31, 2016 was 1.38% and 1.13%, respectively. *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](http://www.BaronFunds.com) or call 1-800-99BARON.*

<sup>1</sup> The Fund has changed its primary benchmark to the MSCI EM (Emerging Markets) Index given its broad acceptance as the standard benchmark measuring emerging markets equity performance. The Fund will maintain the MSCI EM (Emerging Markets) IMI Growth Index as a secondary benchmark. The MSCI EM (Emerging Markets) Index and the MSCI EM (Emerging Markets) IMI Growth Index are unmanaged, free float-adjusted market capitalization weighted indexes. The MSCI EM (Emerging Markets) Index Net USD and the MSCI EM (Emerging Markets) IMI Growth Index Net USD are designed to measure the equity market performance of large-, mid-, and small-cap securities in the emerging markets. The MSCI EM (Emerging Markets) IMI Growth Index Net USD screens for growth-style securities. The indexes and the Fund include reinvestment of dividends, net of withholding taxes, which positively impact the performance results.

<sup>2</sup> The performance data does not reflect the deduction of taxes that a shareholder would pay on Fund distributions or redemption of Fund shares.

<sup>3</sup> Not annualized.



MICHAEL KASS

PORTFOLIO MANAGER

Retail Shares: BEXFX  
Institutional Shares: BEXIX  
R6 Shares: BEXUX

year, we notably outperformed in what proved an unusually strong year for equities worldwide. More significant, in our view, we have outperformed both the EM Index as well as the vast majority of our peers by a wide margin since the inception of the Fund seven years ago. During the fourth quarter, the largest driver of adverse relative performance was stock selection effect in the Information Technology (IT) and Consumer Discretionary sectors. Notable corrections in China-based **Bitauto Holdings Limited**, **Baidu, Inc.**, and **Sunny Optical Technology Group**, which had all experienced substantial appreciation earlier in the year, drove the poor performance in the IT sector. Similarly, within Consumer Discretionary, **Smiles Fidelidade S.A.** of Brazil and **TAL Education Group** of China also corrected after at least doubling since the beginning of 2017. On the positive side, stock selection supported relative performance in Health Care, driven by a product approval and regulatory reform benefiting **Sino Biopharmaceutical Ltd.** of China, and in Industrials, attributed to **Bidvest Group Ltd.** upon the favorable resolution of the ANC electoral process in South Africa. For the full year, significant gains were broad based, with stock selection in Consumer Discretionary and IT contributing the most, while our modest cash position in a strong market was the only notable detractor from relative performance. From a country

# Baron Emerging Markets Fund

perspective, for the year, strong relative performance was driven most by strong stock selection in China, where TAL Education, Sino Biopharmaceutical, Sunny Optical Technology, and **Hangzhou Hikvision Digital Technology Co., Ltd.** each gained over 100%, as well by stock selection effect in India, Brazil and Russia.

**Table II.**  
Top contributors to performance for the quarter ended December 31, 2017

	Percent Impact
Tencent Holdings, Ltd.	0.83%
Sino Biopharmaceutical Ltd.	0.83
FirstRand Limited	0.45
KB Financial Group Inc.	0.45
Bidvest Group Ltd.	0.39

Shares of **Tencent Holdings, Ltd.** increased on the back of strong fundamentals in its gaming and advertising businesses. The company, which operates China's leading social network and messaging platform (QQ and WeChat), largest online entertainment and media business, and the largest online PC and mobile gaming business, reaches almost a billion monthly users. We estimate Tencent will continue to grow all of its large business segments for years to come given its track record of execution, unique online intellectual property and assets, and scale.

Shares of **Sino Biopharmaceutical Ltd.** rose sharply on strong earnings growth fueled by the launch of key blockbuster drugs. As China's leading pharma player with a key focus on R&D, the company is well positioned to benefit from growing demand for health care services in the country. A fast-changing regulatory landscape will also favor established, innovative players such as Sino Bio, in our view. The company has a robust product pipeline that could potentially generate double-digit earnings growth over the next three-to-five years.

**FirstRand Limited** is a South Africa-based provider of banking and insurance services to retail and commercial clients. Shares rose on an improved top-down outlook after the country's ruling party elected Cyril Ramaphosa as its new president. We think Ramaphosa's anti-corruption campaign platform could potentially lead to a more disciplined fiscal policy, improved institutional strength, and better economic growth prospects. As the country's highest-quality bank, in our view, we think FirstRand could benefit from these potential changes.

**KB Financial Group Inc.** provides commercial and consumer financial services in South Korea. The stock rose in the fourth quarter after investor confidence in the country's economic growth rate and policy rate trajectory strengthened. In November, the Bank of Korea hiked rates for the first time since 2011. We believe the rate increase has positive implications for top-line growth at KB Financial and complements other strong bottom-up trends we see for the bank. During the quarter, the company also announced a sizeable share buyback program, which shows its flexibility in using excess capital.

Shares of **Bidvest Group Ltd.**, a leading South African conglomerate, rose during the fourth quarter. Despite a tough macro environment in South Africa, Bidvest reported steady earnings growth in the quarter. Along with other domestically focused businesses, it benefited from the election of a pro reform candidate as the ANC ruling party leader. The company, which

operates in areas including financial services, automotive dealerships, electrical equipment, and freight services, maintained its stellar track record in creating shareholder value by investing in asset-light, high ROIC businesses.

**Table III.**  
Top detractors from performance for the quarter ended December 31, 2017

	Percent Impact
Bitauto Holdings Limited	-0.29%
Ctrip.com International, Ltd.	-0.23
Sunny Optical Technology Group	-0.21
Eclat Textile Co., Ltd.	-0.21
TAL Education Group	-0.20

**Bitauto Holdings Limited** is one of two dedicated online auto financing platforms in China. Shares declined in the quarter following significant gains earlier in 2017 due to profit taking. We retain conviction in Bitauto because the company's core fundamentals remain intact. Online auto advertising and financing sectors remain poised for multiyear growth in China, and Bitauto remains a top player to benefit from that trend.

**Ctrip.com International, Ltd.** is the dominant online travel agent in China. Shares fell in the fourth quarter amid investor concerns about a new Chinese regulation on cross-selling travel methods. We retain conviction. Management believes Ctrip will adjust accordingly, and we think Ctrip's international air business, a rapidly growing segment with high margins, will offset the negative impact of the regulation. Ctrip is well positioned to capitalize on the growing dominance of Chinese travelers globally, and its 1 trillion RMB bookings target by 2020 is achievable, in our view.

**Sunny Optical Technology Group** is an integrated manufacturer of optical-related products in China. Its core business consists of handset camera modules and lenses, as well as vehicle lenses. After a significant run, shares retreated as a result of profit taking and market noises on the smartphone market. We maintain our long-term positive view on the stock as Sunny continues to gain market share in the camera lens business and is creating new growth drivers such as 3D sensing applications.

**Eclat Textile Co., Ltd.** is a Taiwanese supplier of high-tech nylon to the global sportswear industry. Shares fell during the fourth quarter because while the company is the best in its industry, it has been hurt by weak business trends among its customers. We retain conviction. In our view, Eclat possesses strong competitive advantages in fabric and garment technologies that allow it to operate at near-full capacity. With its strong pricing power, it enjoys solid revenue growth, high and stable margins, and high returns on capital.

**TAL Education Group** is a leading Chinese K-12 tutoring company, operating 575 learning centers in 36 cities across China. Shares decreased in price in the fourth quarter as a result of the market's disappointment following a reduction in gross margins due to the rapid expansion phase TAL entered in 2017, as newly opened learning centers take several quarters to mature and reach profitability. 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 and the vast opportunity ahead.

## PORTFOLIO STRUCTURE

**Table IV.**  
Top 10 holdings as of December 31, 2017

	Percent of Net Assets
Tencent Holdings, Ltd.	4.2%
Alibaba Group Holding Limited	4.1
Baidu, Inc.	3.2
KB Financial Group Inc.	2.3
Samsung Electronics Co., Ltd.	2.1
Sino Biopharmaceutical Ltd.	1.9
Sberbank of Russia PJSC	1.8
Maruti Suzuki India Ltd.	1.8
Taiwan Semiconductor Manufacturing Company Ltd.	1.7
WH Group Limited	1.6

## EXPOSURE BY COUNTRY

**Table V.**  
Percentage of securities by country as of December 31, 2017

	Percent of Net Assets
China	31.5%
India	18.3
Korea	6.6
Brazil	6.0
Taiwan	5.2
South Africa	4.6
Mexico	4.2
Argentina	3.7
Russia	3.2
Philippines	2.5
Indonesia	1.9
Hong Kong	1.8
Panama	1.1
Singapore	1.1
Malaysia	1.0
United Kingdom	0.9
Chile	0.7
Thailand	0.7
Nigeria	0.1

*Exposure by Market Cap:* The Fund may invest in companies of any market capitalization, and we have generally been broadly diversified across large-, mid-, and small-cap companies, as we believe developing world companies of all sizes often exhibit attractive growth potential. At the end of the fourth quarter of 2017, the Fund's median market cap was \$11.8 billion, and we were invested approximately 76.8% in large- and giant-cap companies, 16.8% in mid-cap companies, and 1.5% in small- and micro-cap companies as defined by Morningstar, with the remainder in cash.

## RECENT ACTIVITY

During the quarter we initiated several new positions, including two new investments with China A share listings that square with our theme of domestic Chinese businesses targeting global multinationals' share of mainland profits in value-added industries. **Yunnan Baiyao Group Co., Ltd.**

is a 100+ year old company focused on traditional Chinese medicine-based pharmaceutical and personal health products. The company holds the country's #2 market position in toothpaste behind Colgate, and has targeted brand extensions in shampoo and other personal care categories. We believe Yunnan is a likely beneficiary of SOE reform, as private shareholders gained majority control of the company in early 2017 with plans to aggressively target organic and M&A driven growth. In conjunction with the reform above, a recently instituted management incentive plan suggests to us improved corporate and capital efficiency with an emphasis on long-term shareholder value. **Kangde Xin Composite Material** is a leading research-driven, Chinese manufacturer of specialty films and materials, which has steadily been moving up the value-added curve to produce optical films used in LCD and OLED displays, energy efficient glass, and automotive and home appliance applications. We believe the company is currently the only vertically integrated manufacturer in China capable of competing head-to-head with global multinational leaders such as 3M, Eastman Chemical, and LG Corporation. We suspect further market share gains and product extensions, particularly in areas related to environmental protection, are forthcoming. The company was recently listed by Forbes as #47 on its list of the World's Most Innovative Companies. Further, Kangde Xin is a well-managed private sector company with an entrepreneurial culture, with the founding CEO and other employees owning a significant stake. Our third new investment in China during the quarter was **China Construction Bank Corporation ("CCB")**, our first investment in a Chinese state-owned bank, in consideration of our view that China is successfully managing a necessary transition in economic priorities while also improving financial stability and credit quality. We believe the competitive environment in China is shifting in favor of the major banks, and that CCB is in a strong position, given its attractive, low-cost deposit base as liquidity to the non-bank financial sector wanes and yields on incremental loans gradually rise. During the quarter, we also made initial investments in **Tata Global Beverages Limited**, a high-quality consumer group in India, which we believe will benefit from a major internal restructuring with an emphasis on capital and resource efficiency, **Loma Negra Compañía Industrial Argentina Sociedad Anónima**, the country's leading cement producer, which we believe will be a direct beneficiary of an extended reform-driven investment cycle over the coming years, and **Petróleo Brasileiro S.A. – Petrobras**, the leading Brazilian oil & gas group, where we believe management and governance changes have driven solid progress on restructuring and deleveraging, and where we perceive an attractive foundation for future shareholder value creation.

During the year, we developed and invested in new themes related to broad reforms in Argentina, the wealth management sector in India, and in emerging leaders in innovative and intellectual capital-based companies in China. This last theme is focused on value-added industries such as biosciences, consumer products, automation, and artificial intelligence.

During the quarter, we exited several positions due to longer-term fundamental concerns or changes in management or corporate strategy. Such sales include **Catcher Technology Co., Ltd.** and **Novatek Microelectronics Corp.**, both Taiwanese providers of smartphone, display and supply chain solutions, **Amara Raja Batteries Limited** of India, and **Steinhoff International Holdings N.V.**, a South Africa based furniture manufacturer and retailer where we became concerned over an excess of acquisition-related activity. We also exited our position in **Grupo Financiero Banorte, S.A.B de C.V.** because we were uncomfortable with a related-party acquisition as well as upcoming election risk in Mexico.

# Baron Emerging Markets Fund

## OUTLOOK

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In our recent quarterly letters, we have suggested that EM economies and equities had entered a sweet spot, and were likely to exhibit sustainable outperformance. In addition, last quarter we highlighted the positive implications of stable real economic growth and improving credit quality in the Chinese banking system in the context of a tightening of credit to the housing market and the speculative financial economy in China. Given the ongoing strength of the global economy and a contained outlook for inflation, we concluded that the odds of a near-term overshoot to the upside in global, and particularly, international and EM equities were rising. As global growth demonstrated clear acceleration in the fourth quarter amid passage of stimulative tax legislation in the U.S., we believe this overshoot is now underway. We have no prediction as to how far the current optimism will advance in the near term, however, on a forward looking basis, we now believe the global markets are likely at some point in the year ahead to experience increased volatility, and we would not be surprised to see the first notable market correction in some time.

The principal reasons for the shift in our outlook since last quarter are the coordinated acceleration in global growth and rise in confidence, as well as a notable change in official policy orientation in China following the key Party Congress in November. While strong global growth is certainly a good thing, we believe the downside of elevated confidence is a likely rise in future inflation readings and risk of economic overheating; indeed, energy and commodity prices are recently on the rise along with bond yields in several countries. Although equity markets are currently embracing the message, we believe it is likely a matter of time before tight labor conditions drive wage inflation, which we believe would elevate fears of more global tightening than the market is currently discounting. In our view, the balance of a strong economic and earnings environment alongside the rising risk of incremental liquidity tightening, suggests higher volatility is coming, eventually resulting in a cooling off period and a consolidation or broad trading range environment. Importantly, we feel such a consolidation would be a healthy development, curing excess optimism rather than foreshadowing a more concerning decline.

Regarding the policy shift in China, just days after the conclusion of a successful Party Congress where leadership and policy priorities were solidified, a series of official tightening measures were unleashed. While we remarked early last year that this should be within the range of expectations, we were somewhat surprised by the abrupt and comprehensive nature of the communiqués. To summarize, our takeaway is that liquidity and credit to the property, non-bank financial, and asset management sectors will be further constrained. We also expect the relaxation of consumer credit availability, which we reported on in recent

letters, will be partially reversed. It is clear China will prioritize a cleaner environment as well as productivity enhancing and value-added sectors such as Health Care and IT. On balance, we believe economic and credit growth in 2018 is likely to slow on the margin, though financial risks will likely remain contained. To us, the key implication is that while China represented an upside surprise to global growth, corporate earnings, and equity performance in 2017, it may represent a modest drag on growth and earnings expectations in the year ahead. As active stock pickers, we remain focused on the longer-term beneficiaries of the many significant changes occurring in China, and would opportunistically view a correction driven by a pause in growth momentum.

While a market consolidation after the kind of equity appreciation experienced globally in 2017 would not be surprising, we continue to believe that EM outperformance is sustainable, particularly following any global correction. We remain encouraged by ongoing productivity-enhancing reforms in many EM countries, particularly in China and India, two large weights in the EM universe and our largest exposures by country. In addition, many other countries in which we invest are demonstrating a favorable political shift in the direction of investment, business, and capital market-friendly policies. These factors, as well as the fact that most EM economies are less advanced cyclically than the U.S. and certain developed countries, and China's strategy to gain market and profit share from Western multinationals in high value-added sectors, suggest to us that EM equities may not only be early in a sustainable stage of outperformance, but also may perform better than what might be expected when more challenging market conditions emerge.

In conclusion, while we remain in a sweet spot for EM economic growth and corporate earnings, the marked appreciation of the past year, high current optimism, and a likely moderation of abundant global liquidity support cause us to temper expectations for further substantial gains in the near term; however, the longer-term and more secular drivers remain encouraging, and we believe our unique forward-looking and bottom-up, fundamental approach and process position us well to continue to identify attractive EM investments as they arise. Thank you for investing in the Baron Emerging Markets Fund.

Sincerely,



Michael Kass  
Portfolio Manager

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*Investors should consider the investment objectives, risks, and charges and expenses of the investment carefully before investing. The prospectus and summary prospectus contains this and other information about the Funds. You may obtain them from its distributor, Baron Capital, Inc., by calling 1-800-99BARON or visiting [www.BaronFunds.com](http://www.BaronFunds.com). Please read them carefully before investing.*

In addition to the general stock market risk that securities may fluctuate in value, investments in developing countries may have increased risks due to a greater possibility of: settlement delays; currency and capital controls; interest rate sensitivity; corruption and crime; exchange rate volatility; and inflation or deflation. The Fund invests in companies of all sizes, including small and medium sized companies whose securities may be thinly traded and more difficult to sell during market downturns. The Fund 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 manager 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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**Beta:** measures a fund's sensitivity to market movements. The beta of the market is 1.00 by definition.