Jeff Kolitch: Real Estate Equities Are Still Attractive

This is an edited version of an October 18, 2021, Q&A with Jeff Kolitch, Portfolio Manager of Baron Real Estate Fund and Baron Real Estate Income Fund. To access the recording, please dial 800-633-8284, passcode #21997774.

Key Discussion Points

- Introduction and Fund performance
- Why this cycle is just beginning
- Sector views: office, housing, and travel
- Our REIT outlook and the Baron strategy advantage

Introduction and Fund performance

Jeff Kolitch manages Baron Real Estate Fund and Baron Real Estate Income Fund. Jeff has 29 years of investment experience. He joined Baron from Goldman Sachs in 2005 as a real estate research analyst and was promoted to portfolio manager of Baron Real Estate Fund in 2009 and launched Baron Real Estate Income Fund in 2017.

As of September 30, 2021, Baron Real Estate Fund has a cumulative return of 525% (net of fees) since inception, far outdistancing the 308% return of its benchmark, the MSCI USA IMI Extended Real Estate Index, and the 205% cumulative return of the MSCI U.S. REIT Index. The Fund has a 5-star Overall Morningstar Rating™ and is in the top 1% of all real estate funds for its 10-year, 5-year, and 3-year performance, according to Morningstar.

Baron Real Estate Income Fund, which emphasizes real estate dividend paying securities, has a cumulative return of 71% since inception, more than doubling the 31% return of the MSCI REIT benchmark. As of 9/30/21, the Fund also has a 5-star Overall Morningstar Rating™ and ranked in the top 3% of real estate funds for the 3-year period and the top 69% for the 1-year period.

As of 9/30/2021, the Morningstar Ratings™ were based on 231, 199, 147, and 231 share classes for the 3-year, 5-year, 10-year, and Overall periods, respectively. Baron Real Estate Fund received 5, 5, 5, and 5 stars, respectively. The Morningstar Ratings are for the Institutional Share Class only; other classes may have different performance characteristics. The Morningstar Ratings are based on the Morningstar Risk-Adjusted Return measures.

As of 9/30/21, the Morningstar Real Estate Category consisted of 246, 231,199, and 147 share classes for the 1-, 3-, 5-, and 10-year periods. Morningstar ranked Baron Real Estate Fund Institutional Share Class in the 48th, 1st, 1st, and 1st percentiles, respectively.

As of 9/30/2021, the Morningstar Ratings were based on 231 and 231 share classes for the 3-year and Overall periods, respectively. Baron Real Estate Income Fund received a 5-Star Overall Morningstar Rating™ and 5-Star 3-Year Rating. The Morningstar Ratings are for the Institutional share class only; other classes may have different performance characteristics. The Morningstar Ratings are based on the Morningstar Risk-Adjusted Return measures.

As of 9/30/21, the Morningstar Real Estate Category consisted of 246 and 231 share classes for the 1- and 3-year periods. Morningstar ranked Baron Real Estate Income Fund Institutional Share Class in the 69th and 3rd percentiles, respectively.

Morningstar calculates the Morningstar Real Estate Category Average performance and rankings using its Fractional Weighting methodology. Morningstar rankings are based on total returns and do not include sales charges. Total returns do account for management, administrative, and 12b-1 fees and other costs automatically deducted from fund assets.

Q&A with Jeff Kolitch

What fuels your optimism for real estate these days?

This real estate cycle is in its early days. The ingredients that tend to support this asset class are still very much in place. For example:

- **Demand relative to supply** The positive spread between demand and supply that we see right now usually bodes well for occupancy gains, rent gains, new home sales, existing home sales, cash flow growth, et cetera. We don't see excess construction, either in commercial or residential real estate. At the same time, demand, broadly speaking, remains strong for most segments of this asset class.
- **Strong balance sheets and growth potential** We're seeing mostly strong balance sheets and we're not witnessing any troubling warning signs. We continue to uncover value in several segments of real estate. Certain segments have performed quite well, and prospective returns going forward will largely be generated from cash flow and growth in the business. Nevertheless, our team continues to identify companies offering the double-barreled potential of not only business growth but also an improvement in valuation. That's when we can generate returns in the teens or even better.
- **Private equity** An incredible amount of private equity capital has been raised that has yet to be deployed. A recent estimate I've seen is about $300 billion. When you put 70% leverage on that, you get a sense of the magnitude of the buying power, which is approaching $1 trillion of capital targeting yield assets such as real estate.

How do you see work-from-home and flexible work arrangements impacting office real estate?

There's no question that office landlords are facing headwinds. Going into the pandemic, about 5% of the workforce was working from home. There are estimates that percentage could increase to 15% of the workforce. That's not an inconsequential number. Some of that will be offset by many office spaces requiring more space per employee but there will be some demand destruction. When you also consider that many office buildings were built 30, 40, or 50 years ago and need renovation, there's a fair amount of construction being delivered at a time when demand is contracting. That's not a good dynamic for the future prospects of many office landlords.

So, we're long-term cautious on office real estate and landlords, but near-term tactically bullish. What we mean is that we think some stocks have overshot to the downside, creating some reasonably attractive return potential. Office REITs such as **Vornado Realty Trust, SL Green Realty Corp.,**

Paramount Group, Inc., and **Douglas Emmet, Inc.** are trading at 30, 40, or 50 cents on the dollar relative to transactions that have occurred in the private market over the last couple of years. Of course, we are keeping those on a shorter leash relative to the typical longer-term Baron investment.

Where are you most optimistic?

Residential housing Number one is the housing market. We certainly don't have our head in the sand as it relates to some of the near-term headwinds. Perhaps mortgage rates will head higher. And we're well aware of the supply bottlenecks like labor and material shortages. Despite these momentary pauses, our team remains bullish on the multi-year prospects for U.S. residential real estate. We continue to lean into this category as a key investment theme over the next two to four years.

Within this theme, there are several segments of real estate where we continue to find attractive opportunities, including homebuilders, single-family rental REITs, manufactured housing REITs, single family rental REITS, apartment REITs, and technology-centric residential real estate companies.

Our optimism stems from a structural underinvestment that we believe is going to reverse in the years ahead. Estimates point to a structural deficiency of around five million homes since the housing crisis. At the same time, demand prospects are encouraging. Mortgage rates remain low. Consumer savings are high, and the job market is robust. Millennials, the largest age cohort in this country, are entering their 30s and looking to buy or rent a home. Their multi-year delay in household formation is finally reversing. For many, the home became a sanctuary during the pandemic. Working at home means more time at home, which, in turn, means more dollars spent at home. We think this large imbalance is favorable for the housing market over the next three to five years.

Travel-related real estate is another area we are focused on because it remains a cyclically depressed segment of the economy. Many of these stocks – hotels, airlines, gaming, casinos -- hit artificially low levels in the last year or so during the pandemic. After a brief surge at the start of the year, as the Delta variant picked up over the course of the summer many of these stocks pulled back and are down 20% to 50% from their 52-week highs. In our view, that creates the prospect for double-digit annual returns, perhaps a bit higher than in the teens. Again, we focus on balance sheets, making sure these companies have staggered maturities and sufficient liquidity to get to the other side of this pandemic. We are looking at companies that are cyclically depressed, not secularly challenged, and positioned to rebound sharply as more people feel safe to travel again.

Proptech, or digitalization of real estate is our third main area of focus. Real estate has been late relative to many other segments of the economy in embracing technological innovation. Real estate is finally starting to catch up, and we are focused on a number of companies driving or benefiting from the collision of real estate and technology and how it could be supportive in differentiating and competitively advantaging their businesses on a multi-year basis.

What about REITs?

REITs have done well this year after being in the eye of the pandemic storm in 2020. Many of their business models are based on bringing people together -- apartments, office malls, shopping centers, hotels. Our view was that these businesses would rebound as more people were vaccinated and the economy began to reopen. That trend has played out this year, and we think there's more to go. A good number of discounted REITs offer prospects for cap rate compression and improved valuation and growth.

What differentiates the Baron REIT strategy?

At Baron, we tend to do things a bit differently, not for the sake of being different, but because we focus on capturing products with superior returns over a long period of time. As that relates to Baron Real Estate Income Fund, the difference lies in flexibility. For example:

- Most REIT strategies are 100% invested in REITs. In our Real Estate Income strategy, we certainly prioritize REITs, which tend to be 80% to 85% of our investments. But the other 15% or so we leave open for the possibility to invest in non-REIT income-producing real estate-related companies that may, at times, offer superior total returns in the form of more compelling valuations, better growth, superior dividends, et cetera. That's the number one differentiator, and it has served us well over the last several years.
- We're not locked to the benchmark. With no disrespect to our peers, many invest only in companies in the REIT benchmark. Our focus is on identifying the most attractive REITs or income-producing real estate-related companies. We're somewhat indifferent whether they're in the benchmark or not. Although most of our holdings are in the benchmark, a number are not. For example, we will invest in a strong secular growth story such as wireless tower REITs **American Tower Corp.** and **SBA Communications Corp.,** neither of which is in the benchmark. They've been a key component of Baron Real Estate Income Fund for the last several years and have added a lot of alpha.
- We invest in publicly traded real estate debt when we see it trading at a discount to par, and we think those securities can earn equity-like returns higher in the capital structure.
- We have the flexibility to invest in some non-U.S. domiciled real estate or REIT companies.

Are interest rates and inflation a concern for you?

Although I'm sure there are divergent views, there appears to be a general consensus that inflation may remain elevated for a while and perhaps rates will rise. However, the bottom line is that we don't base investment decisions on macro forecasts.

We know our strategies can perform well in a rising rate environment. In the 12 years we have managed our real estate strategy, there have been six periods when the 10-year Treasury has gone up at least 80 basis points. Our strategy performed well relative to any comparative benchmark. In five of those six periods, the strategy generated strong gains. One time it declined modestly by 1.8%.

I think there's a general view that when rates go up real estate doesn't perform well. Over the last year, rates have gone up over 100 basis points since bottoming last spring at around 54 basis points in the 10-year. During that period, our income REIT strategy outperformed the REIT index and gained over 50%.

As for inflation, we believe real estate may be an attractive investment option. Historically, certain real estate businesses have had the ability to raise prices to provide inflation protection. We focus on short lease duration real estate, which can be priced very quickly. Many of the real estate companies that we're invested in have annual rent escalators built into their leases. Again, property values tend to increase for well-located real estate in supply-constrained geographies in inflationary times.

Could you discuss your exposure to China?

Here's the headline message: we have exited our three China-centric holdings and our exposure to Asia real estate in both strategies. We don't have any pure China-centric investments. If you were to add up the exposure across all our companies, it may approach 1% in one of our funds, but it's effectively zero. We sold because we were uncomfortable with the political landscape in China, including the scrutiny of the technology industry. We decided to move to the sideline given that we have many opportunities here in our backyard.

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.

Baron Real Estate Fund's annualized returns for the Institutional Shares as of September 30, 2021: 1-year, 33.50%; 5-years, 19.56%; 10-years, 19.05%; Since Inception (12/31/2009), 16.88%. Annual expense ratio for the Institutional Shares as of December 31, 2020 was 1.08%. The **MSCI USA IMI Extended Real Estate Index**'s annualized returns as of September 30, 2021: 1-year, 32.60%; 5-years, 11.48%; 10-years, 14.51%; Since Fund Inception (12/31/2009), 12.72%.

Baron Real Estate Income Fund's annualized returns for the Institutional Shares as of September 30, 2021: 1-year, 31.24%; 3-years, 19.37%; Since Inception (12/29/2017), 15.29%. Annual expense ratio for the Institutional Shares as of December 31, 2020 was 3.45%, but the net annual expense ratio was 0.80% (net of the Adviser's fee waivers). The **MSCI US REIT Index**'s annualized returns as of September 30, 2021: 1-year, 35.77%; 3-years, 8.82%; Since Fund Inception (12/29/2017), 7.37%.

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 reimburses certain Baron Fund expenses pursuant to a contract expiring on August 29, 2032, unless renewed for another 11-year term 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.

Risks: In addition to general market conditions, the value of the Funds will be affected by the strength of the real estate markets as well as by interest rate fluctuations, credit risk, environmental issues and economic conditions. The Baron Real Estate Income Fund invests in debt securities which are affected by changes in prevailing interest rates and the perceived credit quality of the issuer. The Funds invest 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 discussion of market trends is not intended as advice to any person regarding the advisability of investing in any particular security. The views expressed in this document reflect those of the respective writer. Some of our comments are based on 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 at any time based on market and other conditions and Baron has no obligation to update them.

The **Morningstar Rating™** for funds, or "star rating", is calculated for managed products (including mutual funds, variable annuity and variable life subaccounts, exchange-traded funds, closed-end funds, and separate accounts) with at least a three-year history. Exchange-traded funds and open-ended mutual funds are considered a single population for comparative purposes. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a managed product's monthly excess performance, placing more emphasis on downward variations and rewarding consistent performance. The Morningstar Rating does not include any adjustment for sales loads. The top 10% of products in each product category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars, and the bottom 10% receive 1 star. The Overall Morningstar Rating for a managed product is derived from a weighted average of the performance figures associated with its three-, five-, and 10-year (if applicable) Morningstar Rating metrics. The weights are: 100% three-year rating for 36-59 months of total returns, 60% five-year rating/40% three-year rating for 60-119 months of total returns, and 50% 10-year rating/30% five-year rating/20% three-year rating for 120 or more months of total returns. While the 10-year overall star rating formula seems to give the most weight to the 10- year period, the most recent three-year period actually has the greatest impact because it is included in all three rating periods.

Portfolio holdings for both funds as a percentage of net assets as of September 30, 2021 for securities mentioned are as follows: - **Vornado Realty Trust** - Baron Real Estate Fund (1.3%), Baron Real Estate Income Fund (1.4%);**, Paramount Group, Inc. -** Baron Real Estate Income Fund (2.0%); **Douglas Emmett, Inc.** – Baron Real Estate Fund (1.4%), Baron Real Estate Income Fund (1.5%); **American Tower Corp.** – Baron Real Estate Fund (2.9%), Baron Real Estate Income Fund (5.2%); **SBA Communications Corp.** – Baron Real Estate Fund (1.0%), Baron Real Estate Income Fund (0.8%).

As of September 30, 2021, neither Fund held shares of **SL Green Realty Corp.**

Top 10 holdings as of September 30, 2021

Baron Real Estate Fund

Holding	% Assets
Red Rock Resorts, Inc.	4.0
Brookfield Asset Management Inc.	3.9
Jones Lang LaSalle Incorporated	3.8
Lowe's Companies, Inc.	3.1
CBRE Group, Inc.	3.0
Marriott Vacations Worldwide Corp.	3.0
Boyd Gaming Corporation	2.9
American Tower Corp.	2.9
Simon Property Group, Inc.	2.5
Invitation Homes, Inc.	2.5
Total	31.6

Baron Real Estate Income Fund

Holding	% Assets
Invitation Homes, Inc.	5.7
Equity Residential	5.2
American Tower Corp.	5.2
AvalonBay Communities, Inc.	5.1
Simon Property Group, Inc.	3.9

Travel + Leisure Co.	3.6
Brookfield Infrastructure Partners L.P.	3.6
Prologis, Inc.	3.6
Public Storage Incorporated	3.3
Ventas, Inc.	3.2
Total	42.4

Portfolio holdings are subject to change. Current and future portfolio holdings are subject to risk.

The **MSCI USA IMI Extended Real Estate Index** is a custom index calculated by MSCI for, and as requested by, BAMCO, Inc. The index includes real estate and real estate-related GICS classification securities. The **MSCI US REIT Index** is an unmanaged free float-adjusted market capitalization index that measures the performance of all equity REITs in the US equity market, except for specialty equity REITs that do not generate a majority of their revenue and income from real estate rental and leasing operations. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed or produced by MSCI. MSCI is the source and owner of the trademarks, service marks and copyrights related to the MSCI Indexes. The indexes and the Funds include reinvestment of interest, capital gains and dividends, which positively impact the performance results. The indexes are unmanaged. Index performance is not fund performance. Investors cannot invest directly in an index.

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