Jeff Kolitch: The COVID-19 pandemic, its impact on the real estate markets, and how we are managing our portfolios in response

This is an edited version of an April 1, 2020 Q&A with Jeff Kolitch, Portfolio Manager of Baron Real Estate Fund and Baron Real Estate Income Fund. To access the full recording, please dial 866-595-5357, passcode 0387523#.

Key Discussion Points

Current market conditions
General thoughts on the disruption

Baron Real Estate Fund and Baron Real Estate Income Fund
Fund performance, action plan for the portfolios in response to the downturn, REITS, housing, cruise lines, other real estate-related businesses

Market outlook for real estate and the Baron real estate funds

Current Market Conditions

- ***Could you share your general thoughts on the current crisis?***

  This is a once-in-a-generation exogenous black swan event. The speed of the market correction, job loss, and economy heading into recession has been unprecedented. From peak to trough, the S&P 500 Index dropped close to 35% in just over three weeks. Bear markets typically do not start off that way. It's not a stretch that almost every company is going to be extremely challenged this quarter and likely next quarter or perhaps even the balance of this year.

  We do think the public health crisis will largely be mitigated by some point later this year, given social distancing and other measures that will be in place. That's when monetary and fiscal policy could begin to have an impact, and a rebound in the economy can occur. We believe there are tremendous opportunities in today's market and would remind everyone that bear markets end with recessions.

Baron Real Estate Fund and Baron Real Estate Income Fund

- ***How have the portfolios performed prior to and during the crisis?***

  Both Baron real estate funds have performed quite well both up to and during the crisis. For the period ended December 31, 2019, Baron Real Estate Fund was awarded Morningstar's highest 5-star rating for its 10-year performance and was ranked in the top 2% of all real estate funds for that time period. The Fund also was awarded a 5-star rating for its 3-year performance and ranked in the top 1% of all real estate funds for that time period.

  Baron Real Estate Income Fund, which we launched at the end of 2017, has also had strong performance. In 2019, Baron Real Estate Income Fund gained 36.5%, outperformed the REIT index by more than 1,200 basis points, and ranked in the top 5% of all real estate funds.

  The funds have also held up well in the downturn. In the first quarter of 2020, Baron Real Estate Fund outperformed its primary benchmark by approximately 900 basis points. It is now in the top 1% of all real estate funds in the last 10 years. Baron Real Estate Income Fund outperformed the REIT index by approximately 1,150 basis points in the first quarter.

- ***How are you managing the portfolio? What is driving your recent outperformance?***

  We have chosen to be much more opportunistic and active in managing our portfolios given the unprecedented nature of the economic lockdown, Baron Real Estate Fund's large exposure to travel-related companies, and the extreme stock market volatility we've been seeing. We have been executing on a different playbook than what we typically deploy at Baron Capital, which is more of a lower turnover approach. We've been taking advantage of the volatility in the markets to upgrade the real estate portfolios with a two-pronged approach.

  Step One: Conduct a major portfolio readjustment to protect capital

  In 2019, we positioned Baron Real Estate Fund primarily around four investing themes: REITs, the U.S. housing market, travel-related real estate companies, and technology-related real estate businesses.

  When news of the virus first broke, while we didn't have the visibility and appreciation that this outbreak would evolve into a global pandemic, we knew our exposure to travel-related businesses, which was about 25% of the portfolio, was significantly outsized. We exited a large portion of the Fund's travel-related holdings – hotel, gaming, cruise line, and time share companies -- early in the first quarter at very favorable prices. Given how quickly the crisis was unfolding, we felt it was important that we not ponder, but act.

  We exited Royal Caribbean Cruises Ltd. at an average price of $104 per share. That stock closed on March 31, 2020 at $32 per share, or 70% below our average sale price. We sold Norwegian Cruise Line Holdings, Ltd. at $49 per share. On March 31, its price was $10.96 per share, or 77% below our average sale price. We sold Wynn Resorts Ltd. at $119 per share versus $60 per share on March 31. MGM Resorts International was exited at $24 per share versus a price of $11.80 per share on March 31. We exited our position in timeshare company Marriott Vacations Worldwide Corp. at $111 per share, and the share price was $55 per share on March 31, or approximately 50% lower than our exit price.

  Primarily as a result of our decision to exit the majority of the Fund's travel-related investments at favorable prices, we maintained a large cash position for the first time in the 10-plus years of Baron Real Estate Fund. In the first quarter of 2020, there were periods when we were holding 15% to 19% cash. We thought it was the right thing to do given the extreme uncertainty. This was a very different approach from how we typically manage the portfolio. Until this year, the majority of the time we have been fully invested because of our bullish view of real estate. But the pandemic was an outlier event, and we felt it warranted decreasing our exposure and raising cash in order to protect our capital.

  Step Two: Re-position our funds and start to deploy capital to upgrade the portfolio

  By mid-March, with so many stocks having corrected so sharply, we started to pivot toward thinking about where the market might be in a year or two. Of course, stocks can go lower in the near term, but we think that, given the violent correction we have witnessed, we will see an asymmetrical return profile for equities with significantly higher upside over the next couple of years. We started to deploy the cash that we had raised to buy stocks for both funds. From our perspective, this is a once-in-a-generation, perhaps a once-in-a-career, buying opportunity.

  We began buying stocks in a significant way the week of March 15, which turned out to be the worst week for the S&P 500 Index since 1987. We have continued to layer in cash over the last couple of weeks up until this call and will continue to do so in the weeks ahead.

  Two-part plan to deploy cash, buy stocks, and upgrade the portfolio

  Part One: Buy best-in-class companies whose valuations have corrected

  We are deploying cash to execute on a two-part plan to upgrade and reposition our real estate portfolios. Part one is upgrading the portfolio with what we deem are best-in-class quality companies that prior to the market correction had been too expensive, such as market leaders, wireless tower companies and other secular growth companies, businesses with great balance sheets and excellent management teams who are prudent allocators of capital.

We are doing this across various real estate categories. In the housing segment, it's companies like Home Depot, Inc., The Sherwin Williams Company, D.R. Horton, Inc., and Lennar Corp. We are also investing in leading commercial real estate services firms such as CBRE Group Inc., premier real estate operating companies such as Brookfield Asset Management Inc., best-in-class REITs such as Prologis, Inc., and leading wireless tower companies such as American Tower Corporation.

When we see the stock of Home Depot, the country's leading home improvement center, operating in a duopoly industry structure with minimal leverage, a 4% dividend yield, and a strong balance sheet, correct from $250 to $150, we believe it's appropriate for us to consider buying shares. Or when Sherwin-Williams, a global leader in the paint segment, corrects from $600 per share to approximately $370 range, we start to look to acquire shares. In the housing segment, the two premier home building companies – D.R. Horton and Lennar – are trading at levels that were last seen during the housing crisis. And this isn't a housing crisis where we're overbuilt -- we're actually underbuilt relative to our country's demographic needs. The list goes on. Brookfield Asset Management is a company which six months ago we had conservatively valued in the $80 per share range. The stock is at $41 today. We're hard pressed to believe there's been a 50% loss in the net asset value of this company.

Part Two: Buy cyclical stocks that have declined the most in the downturn

Part two of our plan to upgrade our portfolios is to focus on the companies that have gone down the most in the downturn. When the market bounces back, we believe there is a good chance it is going to be led by more cyclical stocks, many of which look quite cheap on a base case scenario. We think these companies may be more likely to experience the sharpest rebound – potentially 100% to 200% gains in their share prices -- when we begin to recover.

Many of these companies are in the travel-related segment, such as Hilton Worldwide Holdings Inc., in which we had a small position at the end of the year as we were struggling with its valuation. Hilton has an incredible franchise with premiere hotel brands and a strong balance sheet. With effectively all its hotels shuttered, Hilton has well north of a year of liquidity to pay its operating expenses. This was a stock that we exited long ago. The shares corrected from a high of $115 to $44, and we began re-acquiring shares in the $50 range.

Wynn Resorts is a leading casino company with most of its businesses in Macau. It has a strong balance sheet with more than $3.5 billion dollars in liquidity. Its stake in Wynn Macau, which trades in China, is worth roughly $5.7 billion. Wynn's market cap is currently about $5.7 billion, which means the market is ascribing zero equity value to its U.S. operations. That makes no sense to us.

MGM's stock is trading at approximately $11 per share right now. It has a stake in MGM Growth Properties worth about $4.5 billion and a stake in MGM China worth more than $2 billion. The company also has a strong liquidity position. Yet, at its current share price, the market is valuing MGM's U.S operations at less than zero! Yesterday, the new chairman of the board purchased $4 million worth of shares. An activist investor who also is on the board bought a million shares today. We are confident these insiders have an appreciation for the value inherent in this company. We don't think they're likely to put bad money into a situation that the market is treating as if it's headed toward zero.

To recap our action plan in response to the crisis: First, we raised cash early on, taking it to 18% or 19% at its peak, primarily by exiting travel-related companies at very favorable prices. Second, in mid-March, we began to deploy that cash with a two-pronged approach, buying best-in-class companies that we felt had been too pricey prior to the market correction and supplementing that with some cyclical stocks that had gone down the most. We are certainly not calling the bottom, but when we look out over the next couple of years, we think we're positioned well for an attractive outcome. We'll see how that all unfolds.

- ***Could you give us your thoughts on REITs? Why didn't they hold up better in the downturn?***

Year-to-date, REITs overall have not exhibited the typical defensive characteristics that they often exhibit in an economic downturn. Their dividends, contracted cash flows, and largely domestic portfolios have not offered shelter in this storm.

So why has REIT share price performance suffered in the first few months of 2020?

1. We are not experiencing a typical economic downturn. It's unprecedented. The entire economy is shut down -- closed for business. Commercial real estate is the landlord to the overall economy (office buildings, apartment buildings, malls, shopping centers, self-storage, industrial, health care, lodging, etc.).

   So it comes down to a tenant credit issue which could exacerbate financing/balance sheet issues. Are tenants going to pay rent? Likely not in retail or in lodging, perhaps not in apartments and senior housing for a period of time. If the shutdown persists into the fall, this would be a big problem for many REITs, although a 1-3 month rent deferral may be ok.

2. Credit spreads blew out in the last few months, which is a big negative for companies with leverage such as REITs.

3. REIT balance sheets are generally in solid shape but they carry much higher leverage than most non-REIT C-Corps. Net debt/EBITDA is approximately 5 times for the average REIT, versus 1-2 times for non-REITs. REIT balance sheets are generally ok for now, with both sides of REIT balance sheets in the best shape they have ever been. Assets are benefiting from solid portfolio repositioning. Debt and equity are benefiting from lower debt levels and significant debt refinancing, which has extended durations, lowered rates, and staggered debt maturities.

   REITs, however, are always at the mercy of the capital markets -- much more so than non-REIT companies. Why? Because REITs must pay out 90% of taxable income in the form of dividends in order to avoid paying taxes. If the debt markets are not functioning well, which is what happened in the first quarter of 2020, that has the potential to present a big issue for REITs.

4. Defensive cash flows (contracted leases) may not prove to be as defensive as many thought if tenants can't pay rent. The duration of the economic shutdown is critical.

5. It is important to note that beneath the REIT Index level, there has been a wide divergence in REIT returns year-to-date. Data centers, wireless towers, and industrial warehouses (the Amazon effect) have performed well. On the other hand, malls/shopping centers/health care (senior housing exposure)/lodging (no business, leisure travel)/office (people working remotely as we discussed) -- all these groups have struggled.

- ***What is your outlook for the housing market?***

Just four weeks ago, the U.S. housing market, particularly in the critical price point of the entry level home, was performing quite well. Household formation was picking up with solid job growth and wage growth. Various age cohorts were beginning to buy homes, reasonably priced homes were being built, home affordability had improved relative to renting, a 30-year fixed mortgage rate was quite attractive at mid-to-high 3%. And new home construction activity remained below demographic needs.

Today, we don't know if the economic downturn will be a pronounced and long recession or if it will be a short downturn with a sharp economic recovery. So, at this stage, we have a more balanced view on the outlook for housing. Whether consumers are going to be buying homes will depend on the economic recovery, jobs, wage growth, etc.

While there is a case for a less optimistic outlook for the prospects for new and existing home sales, we believe a good portion of the concern is already reflected in share prices. For example, Lennar is trading at 85 cents on the dollar. Four weeks ago, it was trading at 1.7 times tangible book value. This company is one of the world's premier home builders and one of the best allocators of capital. When we think about risk/reward over the next 12 to 24 months, our view is that Lennar is a buy. While we recognize the current outlook for the consumer is uncertain, at 85 cents on the dollar, we like Lennar's risk/reward.

We're constructive on the prospects for repair and remodel spending. With people currently spending more time in their homes, we think we will see more lower ticket repair and remodel spending activities such as refreshing paint jobs and other home improvement activities. So we think a paint company like Sherwin Williams and home improvement companies like Home Depot and Lowe's should benefit.

- ***You mentioned that you exited cruise lines early on. Will there be a point where cruise lines are down so much that they are worth looking at?***

  Before the crisis, we had a positive long-term view of the cruise industry given its oligopolistic structure – the three largest companies have 80% of the market -- and high barriers to entry as a new ship costs as much as a $1 billion, and growing demand.

  Despite the fact that the stocks have gotten crushed, we have not chosen to reengage. In our view, cruises are one segment in the travel-related industry in which the impact from the pandemic will be most pronounced as a result of a significant drop in demand. With news stories of thousands of cruisegoers stuck on ships with people getting sick and dying, we think it's going to take quite some time for demand to recover.

- ***Do you have any thoughts on other possible long-term impacts of the crisis on the real estate sector?***

  While we suspect many things will go back to the way they were, there probably will be some nuances of permanent change as a result of just living through this pandemic. It’s still early in the crisis, however, and frankly we haven't had much time yet to step back and assess and anticipate which changes might be temporary and which might be more permanent in nature.

  For example, will consumer behavior be permanently altered? We don't think so. After this crisis has abated, we believe consumers will start going back to restaurants, sports arenas, casinos, shopping centers. The question will center more on the pace of re-engagement. Except perhaps for cruise lines, we anticipate a large segment of the leisure traveler to come back as well.

  Will business be conducted differently? Perhaps business travelers will cut back on travel and conduct more business via video.

  As for offices, prior to the pandemic we didn't consider this to be a three-to-five year concern, but looking out 15 to 20 years, we have discussed the possibility of office space being in long-term secular decline. We think that dialogue is going to pick up quite a bit. As many firms seem to be functioning reasonably well with people working from home, businesses may start reevaluating how much office space is needed.

  We have been talking about the secular decline of retail real estate for years. Post-crisis, we think retailers will certainly reevaluate the number of physical stores needed.

  On a positive note, with the mobile workforce and people working from home, we think we will see an acceleration in the move towards cloud-based services and digital transformation, which in turn will benefit towers and data centers.

Market Outlook

We don’t want to be dismissive of the severity of the global health crisis, but we are as bullish on the prospects for the real estate market and our portfolios as we’ve been since the emergence after the 2008-09 recession. In our opinion, several tailwinds will emerge that will be quite supportive of real estate once we get to the other side of this health crisis.

First, interest rates are at historic lows. Second, Congress has passed a sweeping fiscal stimulus package that is historic in both size and breadth. Third, most real estate-related stocks are down anywhere from 30% to 80%. That's a once-in-a-career buying opportunity.

Prior to the crisis, we held a very constructive view on the prospects for both commercial and residential real estate. The housing market was beginning to come back as well. Some, however, cautioned that the stock market, including real estate, had appreciated a lot. Fast forward to April 1, and that is obviously no longer the case.

We're not overbuilding in commercial and residential real estate. We have the benefit of virtually unlimited central bank support. And share prices have been absolutely wiped out. For all of these reasons, we have become quite bullish as we consider the one-to-two-year outlook. It is important to remind ourselves that maximum financial opportunity typically exists when the market is most pessimistic, most desperate.

Sitting here today, we believe we have invested in a compelling mix of best-in-class real estate companies and cyclical real estate companies that are poised for a strong rebound.

In Baron Real Estate Fund, we believe we have structured an appropriate mix between REITs and non-REIT real estate-related companies. We are maintaining investments in five key categories: REITs, housing-related companies, technology-related real estate companies, travel-related real estate companies, and other real estate-related companies.

Within Baron Real Estate Income Fund, we continue to prioritize data centers, wireless tower companies, and industrial REITs, all of which are benefiting from secular growth opportunities. We also invested in other niche categories of commercial real estate, including manufactured housing, single family rentals, and cold storage, all of which we think are going to perform well in the next 12 to 24 months.

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 March 31, 2020: 1-year, (2.81)%; 5-years, 1.27%; 10-years, 10.98%; Since Inception (12/31/2009), 11.44%. Annual expense ratio for the Institutional Shares as of December 31, 2018 was 1.06%. The **MSCI USA IMI Extended Real Estate Index**'s annualized returns as of March 31, 2020: 1-year, (19.91)%; 5-years, 0.57%; 10-years, 7.85%; Since Fund Inception (12/31/2009), 8.56%.

Baron Real Estate Income Fund's annualized returns for the Institutional Shares as of March 31, 2020: 1-year, (2.43)%; Since Inception (12/29/2017), 1.04%. Annual expense ratio for the Institutional Shares as of December 31, 2018 was 7.18%, 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 March 31, 2020: 1-year, (21.96)%; Since Fund Inception (12/31/2009), (6.87)%.

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, 2030, 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 Fund 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 Fund invests in debt securities which are affected by changes in prevailing interest rates and the perceived credit quality of the issuer. 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 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.

As of 12/31/2019, the **Morningstar US Fund Real Estate Category** consisted of 221, 197, 136, and 221 share classes for the 3-year, 5-year, 10-year, and overall periods, respectively. Morningstar has awarded **Baron Real Estate Fund Institutional** Share Class 5 stars, 2 stars, 5 stars, and 4 stars for its 3-year, 5-year, 10-year, and overall performance, respectively.

Morningstar calculates the **Morningstar US Fund Real Estate Category** Average 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. As of 12/31/2019, the Category consisted of 256, 221, 197, and 136 share classes for the 1-, 3-, 5-, and 10-year periods. Morningstar ranked **Baron Real Estate Fund** Institutional Share Class in the 2nd,1st, 50th, and 2nd percentiles, respectively.

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 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.

The portfolio manager defines “**Best-in-class**” as well-managed, competitively advantaged, faster growing companies with higher margins and returns on invested capital and lower leverage that are leaders in their respective markets. Note that this statement represents the manager’s opinion and is not based on a third-party ranking.

Portfolio holdings for both funds as a percentage of net assets as of March 31, 2020 for securities mentioned are as follows: - Wynn Resorts Ltd. - Baron Real Estate Fund (2.0%); MGM Resorts International – Baron Real Estate Fund (1.2%), Baron Real Estate Income Fund (1.3%); Marriott Vacations Worldwide Corp. – Baron Real Estate Fund (1.7%); Home Depot, Inc. – Baron Real Estate Fund (3.0%); The Sherwin-Williams Company – Baron Real Estate Fund (1.9%); Lennar Corporation – Baron Real Estate Fund (2.8%); CBRE Group, Inc. – Baron Real Estate Fund (4.9%); Brookfield Asset Management Inc. – Baron Real Estate Fund (4.9%); Prologis, Inc. – Baron Real Estate Fund (3.1%), Baron Real Estate Income Fund (7.7%); American Tower Corp. – Baron Real Estate Fund (3.5% Baron Real Estate Income Fund (7.3%); Hilton Worldwide Holdings, Inc. – Baron Real Estate Fund (0.8%); MGM Growth Properties LLC – Baron Real Estate Fund (1.3%), Baron Real Estate Income Fund (2.1%).

Neither Fund held Royal Caribbean Cruises Ltd., Norwegian Cruise Line Holdings, Ltd., or D.R. Horton, Inc. as of March 31, 2020.

Top 10 holdings for both funds as of March 31, 2020

Baron Real Estate Fund

Holding	% Assets
GDS Holdings Limited	7.1
Equinix, Inc.	5.9
CBRE Group, Inc.	4.9
Brookfield Asset Management, Inc.	4.9
Penn National Gaming, Inc.	4.1
American Tower Corp.	3.5
Vulcan Materials Company	3.3
Prologis, Inc.	3.1
Lowe's Companies, Inc.	3.1
Home Depot, Inc.	3.0
Total	42.9

Baron Real Estate Income Fund

Holding	% Assets
Prologis, Inc.	7.7
American Tower Corp.	7.3
GDS Holdings Limited	7.1
Equinix, Inc.	6.9
Invitation Homes, Inc.	4.6
Rexford Industrial Realty, Inc.	4.3
QTS Realty Trust, Inc.	4.1
Alexandria Real Estate Equities, Inc.	3.7
Penn National Gaming, Inc.	3.7
Americold Realty Trust	3.7
Total	53.1

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. **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. The **S&P 500 Index** measures the performance of 500 widely held large-cap U.S. companies. The indexes and the Fund 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.

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