Jeff Kolitch: The Resilience of Real Estate Equities

This is an edited version of an April 20, 2022, webinar with Jeff Kolitch, Portfolio Manager of Baron Real Estate Fund and Baron Real Estate Income Fund. To access the recording, please visit our website.

Executive Summary

- We believe there is a strong case for investing in real estate -- for portfolio diversification as well the potential inflation protection benefits.
- Despite the risks in this environment, we remain optimistic — even more than we were three or four months ago, given the sharp correction in many stocks since then.
- During the life of our flagship fund, now in its 13th year, there have been six periods during which the 10-year Treasury rose by at least 80 basis points. In each of those periods, our strategy outperformed the index, with solid absolute returns in five of those six periods.
- For those concerned about inflation, we believe real estate is a good place to be. Certain real estate companies can serve as a partial inflation hedge thanks to their ability to raise prices, particularly in supply-constrained markets.
- We do not see the typical conditions that would foreshadow a major real estate correction. Consumer activity is healthy. Corporate balance sheets are liquid. Lending practices are appropriate.
- We believe the market has already discounted many of the reasons for concern. Many stocks are down from recent peaks and valuations are reasonable. Even if there's a bit more downside at this stage, we think the upside is quite attractive over the next several years.

Introduction and Fund performance

Jeff Kolitch manages Baron Real Estate Fund and Baron Real Estate Income Fund. Jeff has 30 years of investment experience. Before joining Baron in 2005, Jeff spent 10 years at Goldman Sachs, starting as a research analyst and moving to managing director in 2002. He launched Baron Real Estate Fund, which invests in REITs and other real estate-related companies, in 2009; and Baron Real Estate Income Fund, which emphasizes REITs and other dividend-yielding real estate companies, in 2017.

As of March 31, 2022, Baron Real Estate Fund has maintained its:

- **1st percentile Morningstar ranking for each of its 3-year, 5-year, and 10-year performance periods**
- **5-Star Morningstar Rating™ for its overall, 3-year, 5-year, and 10-year performance periods**

As of March 31, 2022, Baron Real Estate Income Fund has:

- **1st and 3rd percentile Morningstar ranking for the since inception and 3-year period, respectively**
- **5-Star Overall and 3-year Morningstar Rating™**

As of 3/31/2022, the Morningstar Ratings™ were based on 236, 205, 149, and 236 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 3/31/2022, the Morningstar Real Estate Category consisted of 255, 236, 205, and 149 share classes for the 1-, 3-, 5-, and 10-year periods. Morningstar ranked Baron Real Estate Fund Institutional Share Class in the 96th, 1st, 1st, and 1st percentiles, respectively.

As of 3/31/2022, the Morningstar Ratings™ were based on 236 and 236 share classes for the 3-year and Overall periods, respectively. Baron Real Estate Income Fund Institutional Share Class received 5 and 5 stars respectively.

As of 3/31/2022, the Morningstar Real Estate Category consisted of 255, 236, and 219 share classes for the 1- and 3-year and since inception periods. As of 3/31/2022 Morningstar ranked Baron Real Estate Income Fund Institutional Share Class in the 84th, 3rd, and 1st 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 is your key message for clients in today's environment?

We still believe there is a strong case for investing in real estate -- for portfolio diversification as well as the potential inflation protection benefits.

Our team had a premonition that 2022 would be an arduous year given the prospects of a more hawkish Fed and higher interest rates, the possibility of moderating growth, and some valuation compression for certain real estate sectors. Despite the risks, we remain optimistic — even more than we were three or four months ago, given the sharp correction in so many stocks since the start of the year. In our opinion, many real estate companies remain on sale relative to prior periods and the private market.

What is your outlook on interest rates and the potential impact on real estate?

No one has a crystal ball. Long-date interest rates may or may not head higher. We've been managing real estate for a long time. We know real estate can perform well in a rising rate environment.

During the life of our flagship fund, now in its 13th year, there have been six periods during which the 10-year Treasury rose by at least 80 basis points. In each period, our strategy outperformed the index, with solid absolute returns in five of six periods. In the sixth period, we had a modest decline of 1.8%. Baron Real Estate Income Fund has also performed well since March 2020, when the 10-year Treasury bottomed at 50 basis points, to now where we're bumping up against 3%.

The Fed is about to embark on a quantitative tightening program. The last time it did that was the "taper

tantrum" of 2013-2014. The 10-year Treasury bottomed at around 1.5% and quickly went up to 3%. After some initial bumpiness in the market, what happened? Stocks performed well. The S&P 500 performed well. Real estate performed very well. When the Fed began its taper program, financial conditions had already tightened such that interest rates had peaked and stocks and our Fund performed well. Fast forward to today: There's no question financials have been tightening. Many stocks have corrected. Perhaps most of the damage as it relates to the increase in rates and reset valuations has been done. Jim Bullard, President of the St. Louis Fed, recently commented that the market has already done a fair amount of the work for the Fed.

What are your thoughts about inflation with regard to real estate?

If you are concerned about inflation, real estate is a good place to be. Certain real estate can serve as a partial inflation hedge thanks to the ability to raise prices, particularly in supply-constrained markets. Right now, we're prioritizing short lease duration, or real estate that reprices on a regular basis. For example, hotels reprice every day. Self-storage can reprice every 30 days. Apartments can reprice every year. We hold stock in other real estate companies that have built contractual rent escalators into their leases. This is one reason we think real estate belongs at the top of the list of investible assets.

Are you still positive on travel-related real estate companies?

Yes. In our view, many of these businesses are cyclically depressed, not secularly challenged, and will recover as the economy reopens. The balance sheets of many of these companies are in good shape. Consumers are prioritizing experiences such as travel over goods. Private equity is targeting travel.

We think many travel-related companies are attractively valued with potential to generate annual returns well into the mid-teens, if not higher, over the next couple years. Many of these stocks have bounced off their bottom but remain significantly below their 52-week highs. Casino companies such as **Las Vegas Sands Corporation, MGM Resorts International,** and **Red Rock Resorts, Inc.** are 20% to 50% below recent highs. Certain hotels such as **Hilton Grand Vacations, Inc**. have also corrected. We recently added **Vail Resorts,** a stock that corrected 30% from $370 to $260 in the last few months.

At the outset of 2022, we were bullish about this segment as we believed pent-up demand for travel would be unleashed. We're still optimistic, but we're modestly tempering that enthusiasm and monitoring our exposure given the potential for a slowdown in consumer discretionary spending.

Brookfield Asset Management remains a top holding. Could you comment on the company?

We're big fans of **Brookfield Asset Management, Inc**. When we launched Baron Real Estate Fund more than 12 years ago, it was our largest position. As of March 31, 2022, Brookfield Asset Management is our second largest position. This is one of the largest owners and operators of real estate infrastructure assets in the world. CEO Bruce Flatt is, in our opinion, is one of the best allocators and investors in the world. He's been dubbed "the Warren Buffet of Canada."

We see two positive dynamics. First, there's an ongoing shift of trillions of dollars from traditional investment vehicles to alternatives such as real estate infrastructure and private equity. Second, Brookfield is growing its market share of this ever-expanding pie for three reasons: 1) global scale; 2) operating experience and an amazing operating platform; and 3) an outstanding long-term track record. Brookfield's management tends to set expectations low and then beat them. They believe they have the building blocks to grow the share price from $55 today to $150 over the next four to five years.

Can you talk a bit about gaming – specifically the addition of Las Vegas Sands, and Penn National?

As a leading casino owner in Macau and Singapore, Las Vegas Sands has been in the eye of the pandemic storm for more than two years. Last year, it was a $67 stock. We reacquired it at $34 in the fourth quarter of 2021 and added to it in the first quarter of 2022. We think it is positioned for strong growth

when tourism rebounds in Asia. Macau and Singapore are likely to follow the trajectory of the sharp recovery in 2021 in Las Vegas. The company has an investment grade, liquid balance sheet. We see limited downside and a lot of upside over the next few years. **Penn National Gaming** is a small position. It is a wonderful regional gaming company and omnichannel platform with a strong balance sheet and talented CEO. With a stock price in the high thirties, we think it's ridiculously cheap. You're getting more than 40 casinos at a highly discounted price as well as its ancillary businesses effectively for free.

Are you still bullish on the housing market, given the sharp increase in mortgage rates?

We remain long-term bullish but near-term cautious on the U.S. housing market. The long-term case is simple: we have a structural deficiency relative to our demographic needs. Underinvestment has been happening since the 2008 subprime mortgage crisis. In the 10 years that followed, about 850,000 to 900,000 homes were built per year. In the last three years, it has increased to about a million and a half new homes per year. That's the same number as in the 1950s and 1960s, when the population was 80 million people, not 330 million. The millennial generation, the largest in the U.S., are now buying homes.

We are short-term cautious because homes have become expensive, wage growth has not kept pace with home price appreciation, and mortgage rates have spiked. Home prices increased about 20% in 2021 and about 10% in 2020. In the first few months of this year, mortgage rates have gone from 3% to about 5%. That creates some sticker shock. The housing market needs to cool off. We exited most of our housing-related exposure earlier this year.

Do we think we are headed for a housing crash? No. This is different from what happened in 2008. Back then, our country was building about two million homes a year. Mortgage underwriting standards were largely nonexistent. Demand dried up during the financial crisis and home prices crashed. Now we have pent-up demand, where people have been delaying home purchases for years.

While we’re near-term cautious on the sale side, we’re bullish on housing rentals, as there’s less of an affordability issue.

We cut our homebuilder exposure by half at the start of the year. Since then, many of these stocks have corrected 30% to 50%. In our opinion, those shares have discounted a good portion of the upcoming slowdown and are attractively valued. Given the discounted valuations and compelling long-term prospects, there's a reasonable chance we will increase our exposure in the months ahead.

You have added Blackstone's private, non-traded product to the portfolio. What drove that decision?

This addition is based, in part, on the shift in capital to alternative asset managers. We believe **Blackstone Inc.** embodies several of the characteristics of a great business, including a premier brand, global franchise, and loyal customers. The company is fast growing with limited needs for capital, produces high cash flow margins, and is anchored by a recurring revenue base. We added Blackstone as a tactical buying opportunity. The shares corrected from $150 earlier this year to the low $100s. With its 4.6% dividend yield and strong prospects for growth, we are optimistic about the long-term potential.

Do you think REITs are still attractive?

We do. Growth prospects are encouraging for most categories of real estate. Balance sheets are strong. Several REITs remain on sale. Rising interest rates always tend to be a bit of a headwind, but the inflation protection element that many REITs offer is overriding that. Against a backdrop of multi-decade highs in inflation, investors are looking to real estate. When you can layer on attractive growth earnings visibility with leases, attractive dividends and strong balance sheets, REITs are a good place to be.

Prime examples are industrial logistics REITs. **Prologis, Inc.** and **Rexford Industrial Realty, Inc**. recently reported Q1 results. Leases in their portfolios are, on average, about 50% below market, so they have an embedded growth outlook of 50% over the next several years. Given potential inventory shortages and

lack of new development, there's a good chance rents are headed higher. How many companies can you invest in today knowing you have contractually locked in your ability to increase rents? Leases that turn over on a regular basis offer inflation protection on top of substantial growth opportunities.

Many investors use ETFs for their real estate allocation. Why should they consider an active strategy?

There was a time, maybe 10 or 15 years ago, when a passive strategy was probably a reasonable option. Multi-year prospects for occupancy gains, rent gains, and cash flow growth were generally attractive across all segments of real estate. Today's landscape is very different. It takes a more discerning eye to analyze and evaluate prospective real estate investments. Several segments of real estate will likely face headwinds over the next several years. How will the work-from-home dynamic impact the office market? What will the growing trend of people moving to the suburbs mean for urban real estate? As digital communication and e-commerce grow, how will business travel or brick-and-mortar retail fare?

To put it another way, with a passive strategy, you own everything, the good and the bad. An active manager such as Baron can identify and prioritize opportunities within attractive market segments while de-emphasizing the segments we believe to be more likely to struggle.

How do you address the issue of expenses for active versus passive?

Our returns are always quoted net of our fees, so it's an apples-to-apples comparison versus a passive strategy. Compared with many of the more prominent real estate ETFs, the outperformance, net of fees, for both of our products is significant.

What is your outlook for office real estate?

We're long-term cautious. There's no question the work-from-home trend is a headwind for office landlords, putting pressure on occupancy and rents over the next few years. About 5% of the workforce was working from home pre-pandemic. If the post-pandemic level stabilizes at 15%, we're looking at an incremental 10% headwind to office demand over time. Keep in mind that there was a fair amount of new supply slated to come on the market pre-pandemic as well.

Short term, we see a tactical opportunity to generate positive returns. We think many office stocks have overshot to the downside and offer reasonable value. We're looking at a few companies that we believe are trading at 30% to 40% to, in one case, 50% discounts to liquidation value. We're not suggesting they will move up to net asset value or liquidation value, but we see attractive upside.

Does anything pose a substantial concern for you in this environment?

We don't see the typical conditions that would foreshadow a major real estate correction. Our analysis always begins with the economics of real estate demand relative to supply. That set-up is attractive across most categories and markets we're evaluating. Consumer activity is healthy. Corporate balance sheets are liquid. Lending practices are appropriate. The warning signs just aren't in place.

We believe the market has already discounted many of the reasons for concern. Many stocks are down from recent peaks and valuations are reasonable. We're not suggesting they can't go or that there won't be more volatility. But even if there's a little bit more downside at this stage, we think the upside is quite attractive over the next several years.

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, 2022: 1- year, -0.09%; 5-years, 17.08%; 10-years, 15.14%; Since Inception (12/31/2009), 15.85%. Annual expense ratio for the Institutional Shares as of March 31, 2022, was 1.05%. The **MSCI USA IMI Extended Real Estate Index**'s annualized returns as of March 31, 2022: 1-year, 8.28%; 5-years, 10.44%; 10-years, 11.51%; Since Fund Inception (12/31/2009), 12.27%.

Baron Real Estate Income Fund's annualized returns for the Institutional Shares as of March 31, 2022: 1-year, 16.97; 3-years, 21.24%; Since Inception (12/29/2017), 15.86%. Annual expense ratio for the Institutional Shares as of March 31, 2022, was 1.08%, 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, 2022: 1-year, 25.02%; 3-years, 9.92%; Since Fund Inception (12/29/2017), 9.14%.

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.

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Portfolio holdings for both funds as a percentage of net assets as of March 31, 2022, for securities mentioned are as follows: - Brookfield Asset Management, Inc. - Baron Real Estate Fund (5.1%), Baron Real Estate Income Fund (1.4%); **Las Vegas Sands -** Baron Real Estate Fund (2.8%), Baron Real Estate Income Fund (2.2%); **Red Rock Resorts** – Baron Real Estate Fund (2.9%), Baron Real Estate Income Fund (1.6%); **Hilton Grand Vacations, Inc.**– Baron Real Estate Fund (1.9%); **MGM Resorts International** – Baron Real Estate Fund (3.8%), Baron Real Estate Income Fund (2.7%); **Vail Resorts** – Baron Real Estate Fund (2.3%), Baron Real Estate Income Fund (1.0%); **Penn National Gaming** – Baron Real Estate Fund (1.7%), **Prologis Inc.**– Baron Real Estate Fund (1.3%), Baron Real Estate Income Fund (1.9%); **Rexford Industrial Realty** – Baron Real Estate Fund (1.2%), Baron Real Estate Income Fund (1.7%); **Blackstone Inc.**– Baron Real Estate Fund (1.7%,), Baron Real Estate Income Fund (1.4%).

Top 10 holdings as of March 31, 2022

Baron Real Estate Fund

Holding	% Assets
Boyd Gaming Corporation	5.4
Brookfield Asset Management Inc.	5.1
Jones Lang LaSalle Incorporated	3.9
MGM Resorts International	3.8
Marriott Vacations Worldwide Corp.	3.6
American Tower Corp.	3.4
Equity Residential	3.1
CBRE Group, Inc.	3.0
Travel + Leisure Corp.	3.0
Red Rock Resorts, Inc.	2.9
Total	37.2

Baron Real Estate Income Fund

Holding	% Assets
Public Storage Incorporated	5.7
Equity Residential	5.4
AvalonBay Communities, Inc.	5.4
Ventas, Inc.	4.9
American Tower Corp.	4.2

Vornado Realty Trust	3.6
Boyd Gaming Corporation	3.6
Brookfield Infrastructure Partners L.P.	3.5
Invitation Homes, Inc.	3.2
Travel + Leisure Corp.	2.8
Total	42.3

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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