Baron Funds®

September 30, 2018

Quarterly Report

"Why don't you speak about the straw that will break the back of the bull market." Chairman and CEO. Large Investment Bank. October 2, 2018.

Before I prepare the "final final" draft of my annual Baron Investment Conference speech, it's never really "final" until *after* I have given it, I speak with friends to ask for suggestions on topics they believe would be of interest to Baron Funds' shareholders.

When, in the first week of October, I asked the CEO of one of the largest U.S. investment banks for ideas, my friend didn't hesitate. Most investors, he believed, and spoken like the trader he used to be, would like to hear what I thought would cause the bull market that began in March 2009 to end.

"What everyone wants to know pre-midterm elections, will be different post the elections," he told me. "Whatever we discuss now will be overwhelmed by the results of those elections in just five weeks."

He then listed several unpredictable "macro" events that could be troubling. Presently, things seemed pretty good, he thought, which would likely continue to be the case. "But, a successful cyberattack by a foreign power; the inability to fund budget deficits in Southern Europe; and, whether the balance sheet of Germany could afford to absorb $2 trillion of Italian debt was of some concern." Further, the U.S. economy is presently quite strong with wages increasing faster than expected. "Assuming interest rates continue to increase gradually, higher rates will not be an issue." But, if the Fed believes inflation is increasing faster than anticipated and the Fed is "behind the curve," that could be an issue. "In 1994, in a very strong economy, interest rates increased 300 basis points in 12 months. At one point, the Fed raised rates 75 bps and were raising them between meetings."

But, in his opinion, "*the most discomforting issue is market structure.*" The proliferation of ETFs has given traders an ability to invest in bond ETFs that own illiquid underlying securities. There are now $1 trillion invested in bond ETFs and few investors are even sure what is in those ETFs. Further, people have been leveraging those ETFs like equities. My friend called these "**structured products the grandson of portfolio insurance and the son of credit default swaps ('CDS').**"

RONALD BARON
CEO AND CHIEF INVESTMENT OFFICER

"Portfolio insurance" is what exacerbated the Crash in 1987 and significant CDS counterparty risk had an important role in the financial crisis 10 years ago. Further, "HFTs, high frequency algorithmic traders, presently account for more than half of the daily trading volumes. Since HTFs are generally undercapitalized, a mistake or just a fat finger, could hit markets like a hurricane!"

In my opinion, the dramatic 10% market "correction" in the month of October was caused by exactly the market structure issues my friend described to me four weeks ago. It was not the result of any important change in business fundamentals or prospects. Which shows exactly how smart he is...and why he was able to become the Chairman of this bank from his start in an urban "hood."

One more thing. When I told him about our Growth + "Values" themed meeting on November 9, he warned me not to be sanctimonious. "You are not the kind of investor who would only invest in renewables. People are excessively focused on ESG (environmental, social and corporate governance). You are obviously more likely to invest in a company run by Howard Schultz who puts a nice picture on his coffee cup and not so much in Gordon Gekko who thinks greed is good." "Where do you want to be on the curve?," was his advice. "Invest in Tesla because Elon is a genius and saving the world or not because you are concerned that he is trampling on the rights of his shareholders? It is reassuring to investors," he told me, "that your firm invests in companies with good values. That is what will enable those businesses to have sustained and growing profitability. Favorability matters. You are clearly not going to invest in a business that is going to addict teens. Your cut point is not to invest in businesses that society ultimately won't tolerate. Baron is not going to traffic in something that the world could condemn."

"I hate stocks. I hate the stock market. I hate mutual funds. I want to sell everything." October 11, 2018.

An unusually talented individual with whom we had invested when he was building a large publicly-owned business many years ago invested $50 million in Baron Funds earlier this year. He called on the day in early October that the Dow had fallen 800 points. "I hate stocks. I hate mutual funds. I want to sell everything. I think I would prefer to be a lender rather than an investor in stocks," he told me.

I answered that he should think about his investments with us as investments in businesses that just happen to be publicly traded. That means he can sell or buy at any time he wishes at our Funds' net asset values. This is regardless of whether his investments are priced fairly, or below or above what he believes are the intrinsic values of those businesses. "The market doesn't tell you what a business is worth. Only the price you can pay or receive for the portion of it you own on a given day."

When I began to describe several of the businesses in which Baron Funds has invested, he stopped me when I spoke about **Hyatt Hotels Corp.** "I understand. I have known Tommy (Tom Pritzker, Hyatt Hotel's Chairman) for a long time. OK. I like the idea of investing in companies like that. Thanks for explaining."

Before we ended our call...he changed his mind...or I guess you could say I changed his mind...about selling. I told him that we know each other since 1980. I also mentioned that there were many periods when his company's stock price had been depressed. We didn't sell then since we didn't think his

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share price on any particular day changed the value of his business...either in the short term or the long term.

I also reminded him that he twice spoke at our annual meetings and told our shareholders that he didn't enjoy speaking with most analysts, but that when he began to speak with me regularly, he actually "looked forward to our conversations." He then responded, "You're right. You did ask different questions than others and you were always focused on long-term ideas, not the short term. Congratulations on owning **Vail (Resorts, Inc.)** for more than 20 years and making so much money on that investment. What a great business. I would like to be an investor in Vail, too." "You are," I told him. "One more point. We have 36 other analysts and investors working with me who are much younger than I am; are really smart; and, many of whom, have been working with me for a really long time...and have become great at asking questions, too!" "Okay. Don't sell. If I feel better about things next year, I'll consider adding to my investments in Baron."

"Aren't you worried about the markets? The news sounds absolutely dreadful." Television financial news anchors. October 2018.

Ten years ago, on the morning of Baron Funds' October 24, 2008 annual meeting, the market was "limit down!!!" It could not open since there were virtually no buyers...only sellers. This was after the Dow had already fallen to 8,000 from its 14,000 peak the year before. That morning there were numerous stories in general interest newspapers and the financial press predicting an impending second Great Depression and Dow Jones 2000!!! Pandemonium prevailed.

At 7 AM that Friday, Henry Fernandez, Founder and CEO of financial index provider MSCI, and I were interviewed on CNBC's Squawk Box. Henry is an immigrant from Nicaragua. His dad had been a general in the Nicaraguan Army and, after a government coup d'etat, had to flee with his family to America to avoid being murdered. Henry and I spoke about the great democracy in which we live; how we expected our country to emerge from the financial panic then taking place stronger; and, how investment opportunity was everywhere. Baron was and remains a large shareholder in MSCI. MSCI's stock price was $15 per share. MSCI's share price is now $145 per share. Baron and Henry have each made more than $350 million on their MSCI investments in the past 10 years, almost 10 times the October 24, 2008 price for this unique and important business.

According to HFR, a hedge fund research firm, hedge funds that "hedge against risk" missed most of the stock market rally since 2008. According to HFR, the average hedge fund has increased about 75% since December 2008, about one-quarter what an investor could have earned if he or she had invested in a low fee index fund! Since $3 trillion is still invested in hedge funds, individuals who might otherwise invest in stocks still exhibit "fear and loathing" of equities. While it is not determinative, and we don't invest on this basis, investors are generally optimistic at the beginning of a significant stock market decline and negative at the beginning of a stock market advance. Our strategy is to invest in strong growth businesses and not worry so much about the stock market.

U.S. stock prices reflect the growth in GDP and our standard of living. Entering 1968, 50 years ago, the GDP of the United States was $862 billion. Today it is nearly $21 trillion. Approximately 23 times greater. That represents 6.5% compound annual growth rate ("CAGR"). The Dow Jones in 1968 was trading mostly in the 900s. Today it is close to 25,000. 25 times greater. That represents about 6.6% CAGR. Einstein was right. It's all about compounding! We expect growth in the United States during the next 50 years to exhibit a similar trajectory. In fact, we would not be surprised due to rapidly advancing technology, improved health care and likely greater inflation, if economic growth *accelerated*. Since we try to invest in companies that are growing 15% per year, not the 7% per year of the stock market and economy, we expect over the long term to continue to perform better than market benchmarks and our economy. Of course, we cannot guarantee that.

Every 25 years, the standard of living doubles. A middle-class person now lives better than the wealthiest person on Earth 100 years ago. Better health. Better services.

The average middle-class person today has a higher standard of living than Henry Ford, John Rockefeller, Andrew Carnegie, Henry Phipps and Andrew Mellon 100 years ago. We are as certain that the average middle-class person 100 years from now will enjoy a higher standard of living than Gates, Buffett, Zuckerberg, Musk, Bloomberg, Bezos, Soros, and Icahn today. In large part because of their philanthropies.

Just like the Pharaohs of Ancient Egypt couldn't take their wealth with them...although they tried...neither can today's entrepreneurs...nor by their incredible generosity unlike the Pharaohs of ancient times do they evidence any signs of wanting to do so.

Baron Investment Conference 2018. November 9, 2018. Metropolitan Opera House, Lincoln Center. New York City.

We hope you will be able to attend our 27th Annual Investment Conference on November 9. It is unusual for investment firms to invite their shareholders and clients to meet and question the chief executives of businesses in which their savings have been invested and to meet and question the investment firm's managers and analysts about those investments. At Baron, we believe in providing our shareholders with unique insights and access to the entrepreneurs and businesses that are innovating and improving our world to see first hand the opportunities we see.

One lucky Baron Funds' shareholder attendee without an employment or business relationship with the Firm will win an "*electrifying*" prize, just like last year. For those of you who can't attend, you will be able to watch a live webcast on the Baron Funds' website (except for the entertainment, which we are contractually prevented from streaming). You can also get a sense of our meeting by watching CNBC's Squawk Box that morning from 6 a.m. to 8:30 a.m. EST, when I will appear with several of our speakers and executives.

We hope when you attend our annual conferences or watch us on CNBC or visit our website, you will gain a better understanding of the businesses in which we invest, the character and talent of their executives, as well as the people who work at our Firm.

Thank you for joining us as fellow shareholders in Baron Funds. We will continue to work hard to justify your confidence in us.

See you on November 9th.

Ronald Baron
CEO and Chief Investment Officer
November 1, 2018

Portfolio holdings as a percentage of net assets as of September 30, 2018 for securities mentioned are as follows: **Hyatt Hotels Corp.** - Baron Asset Fund (1.1%), Baron Partners Fund (8.8%*), Baron Focused Growth Fund (11.9%), Baron Real Estate Fund (2.3%); **MSCI, Inc.** – Baron Growth Fund (4.6%); **Vail Resorts, Inc.** – Baron Asset Fund (4.8%), Baron Growth Fund (8.2%), Baron Partners Fund (10.8%*), Baron Focused Growth Fund (16.5%).

*%of Long Positions

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

Baron Funds
Net Realized and Unrealized Gain ($ in millions)
As of September 30, 2018

	Baron Asset Fund	Baron Growth Fund	Baron Small Cap Fund	Baron Opportunity Fund	Baron Partners Fund	Baron Focused Growth Fund	Baron International Growth Fund
MSCI, Inc.	$(2.9)	$334.8	$4.2	$1.2	$14.0	$0.9	$0.1

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. Please read them carefully before investing.

Risks: All investments are subject to risk and may lose value.

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.

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