



## Baron Funds Annual Report

July 2018

Fund Information				
Ticker	BEXIX	BEXFX	BINIX	BIGFX
Asset Class Category	Emerging Markets	Emerging Markets	International Growth	International Growth
Share Class	Institutional	Retail	Institutional	Retail
Min. Initial Investment	\$1 million	\$2,000	\$1 million	\$2,000
Availability*	S, A, F	SO, AN, FN	S, A, F	SO, AN, FN
Expense Ratio <sup>1</sup>	1.10%	1.36%	0.95%	1.20%
Opinion	<i>Recommended</i>	<i>Recommended</i>	<i>Recommended</i>	<i>Recommended</i>
Firm	Baron Capital			
Manager	Michael Kass			
Phone	800-992-2766			
Web Address	www.baronfunds.com			

<sup>1</sup>Certain restrictions apply. Please check with your broker/dealer for details. Key: A = TD Ameritrade, AN = TD Ameritrade, no transaction fee, F = Fidelity, FN = Fidelity, no transaction fee, S = Schwab, SO = Schwab OneSource, no transaction fee

We recently talked with Michael Kass, portfolio manager of Baron Emerging Markets and Baron International Growth, to discuss these strategies and get his thoughts on the current macro environment.

### Investment Environment & Opportunity Set

Kass said the threat of protectionism has become more dangerous lately and has eroded the market's confidence in risk assets in general, not just emerging markets. It may take some time for this confidence to be restored, he added. Speaking to China, Kass thinks the protectionist rhetoric could cause short-term dislocation of supply chains, potentially hurting the multiples applied to certain Chinese companies. As such, he has only marginally reduced his Chinese exposure to around "market-weight," recognizing a political resolution to stabilize the situation may yet be presented and lead to a broad-based rally in emerging-market (EM) stocks.

Latin America has seen relative underperformance so far this year. There had been positive reforms in parts of this region, such as a shift away from state economic intervention and an improvement in corporate governance whereby rights of capital owners were better respected. Kass says these market-based reforms have unexpectedly moderated in countries like Argentina

and Brazil. A major reform in Brazil, for example, had been to reduce the population's reliance on subsidized energy in favor of market-based pricing. As oil prices rose sharply in 2018 the burden of this higher cost fell on the general population. To mitigate this unpopular outcome, politicians (who are facing an election this year) decided to walk back some of the reforms, diminishing the market's confidence somewhat.

### Investment Philosophy & Process

Kass believes the best way to compound wealth is to invest in businesses with long-term competitive advantages and substantial open-ended, long-term growth potential. Importantly, these businesses need to be run by entrepreneurs with the strategic vision and financial sophistication to sustain an above-average return on capital, and who have also instituted shareholder-friendly corporate governance.

Typically, companies with open-ended, long-term growth potential are benefiting from innovation (which may or may not be company specific) or some secular change, which may be regulatory, economic, or demographic in nature. In essence, these changes or themes may "lead to a step-function change" (i.e., significant or transformational) in the returns or profitability a company can generate over a long period.

Baron Emerging Markets Top 10 Holdings (6/30/18)	
Tencent Holdings	4.2%
Alibaba Group Holding	3.8%
Sberbank of Russia	2.3%
Samsung Electronics	2.2%
China Construction Bank	1.9%
Baidu	1.8%
Housing Development Finance Corp.	1.8%
KB Financial Group	1.8%
Kotak Mahindra Bank	1.6%
CSPC Pharmaceutical Group	1.6%
<b>Total</b>	<b>23.0%</b>

Baron Emerging Markets Top Five Sectors (6/30/18)	
Information Technology	21.1%
Financials	19.5%
Consumer Discretionary	12.6%
Consumer Staples	10.9%
Health Care	6.7%
<b>Total</b>	<b>70.8%</b>

Baron Emerging Markets Top Five Countries (6/30/18)	
China	32.3%
India	17.2%
Korea	7.1%
Taiwan	6.1%
Brazil	5.5%
<b>Total</b>	<b>68.2%</b>

When it comes to profitability, Kass places more emphasis on return on capital than on return on equity. The latter, he says, can be driven higher through leverage (e.g., a company taking on more debt to boost its earnings), which can expose a company to economic downturns. Kass avoids excessively leveraged companies. To be confident that a company will be able to sustain high returns on capital, Kass wants to see a sustainable competitive advantage that will give it pricing power and allow it to maintain relatively high margins over a long period. He also wants to see a high degree of “financial sophistication” in management, meaning he wants to see companies manage cash needs prudently and invest the cash they generate in higher-return projects.

Baron International Growth Top 10 Holdings (6/30/18)	
Wix.com	2.6%
Constellation Software	2.4%
argenx	2.0%
Mellanox Technologies	2.0%
TechnoPro Holdings	1.9%
Domino's Pizza Enterprises	1.8%
Danone	1.8%
AstraZeneca	1.8%
Golar LNG	1.7%
Abcam	1.6%
<b>Total</b>	<b>19.6%</b>

Baron International Growth Top Five Sectors (6/30/18)	
Information Technology	25.6%
Health Care	13.1%
Industrials	12.7%
Financials	10.8%
Consumer Discretionary	10.3%
<b>Total</b>	<b>72.5%</b>

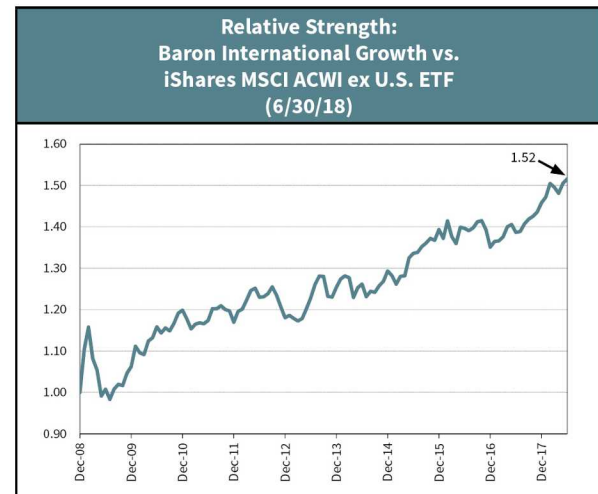
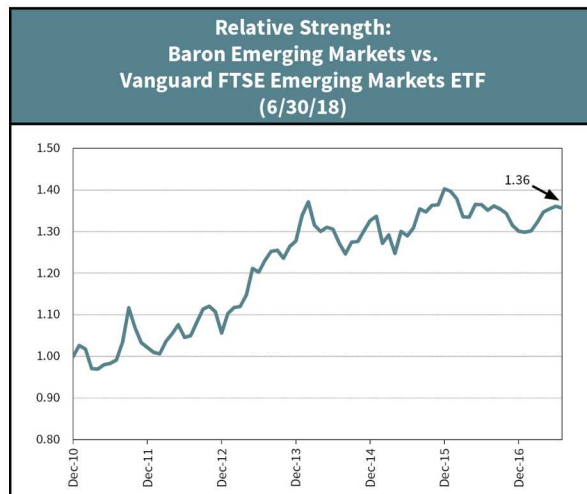
Baron International Growth Top Five Countries (6/30/18)	
Japan	15.3%
United Kingdom	9.5%
China	8.6%
France	5.7%
India	5.1%
<b>Total</b>	<b>44.2%</b>

Kass tends to avoid deeply cyclical and commodity-oriented businesses as they often have volatile and unpredictable earnings streams and generally do not achieve returns on capital substantially above the companies' cost of capital on a sustainable basis. That said, he may selectively add some if he sees strong inflexion in profitability and reasons why it can sustain beyond a shorter-term or cyclical horizon and if that view is severely underpriced by the market. It's fair to say that Kass' hurdle to investing in commodity and cyclical sectors is higher than in other areas. Given this set of criteria, a relatively large subset of companies typically present in an EM stock index is generally not part of Kass's investment opportunity set.

Kass and the analysts place a lot of emphasis on meeting company management teams, suppliers, customers, regulators on the ground, consultants and industry experts, and local sell-side analysts. Ultimately, the analysts build detailed models forecasting earnings and cash flows three to five years out. Models help identify key drivers or swing factors and are actively updated and utilized both prior to purchasing a stock and during ongoing monitoring. A stock becomes a candidate for purchase if Kass and his analyst team see upside of about 100% over three to five years. Typically, most of the upside in a stock stems from their view on how fast the company can grow its earnings or cash flows. An expectation of expansion in valuation multiples is seldom central to Kass's purchase decision.

## Highlighted Positions

One theme Kass has identified is the potential for mainland Chinese companies to take market share from foreign-domiciled multinational companies. “Made in China 2025” is a government-directed strategic initiative to move China's manufacturing capabilities up the value chain. Associated with this vision is what Kass notes to be a sense of Chinese nationalism that could fuel enthusiasm for local businesses. He and his team have identified Chinese companies that potentially stand to benefit from capturing a higher share of profits at the expense of multinational competitors. Currently, this theme has a roughly 7% allocation in the EM strategy.



One company within this theme is drug maker **Yunnan Baiyao**, the no. 2 player in its market with a brand that's over 100 years old. This name—added in the fourth quarter of 2017—has a weighting of 1.2% in Baron Emerging Markets. An appealing feature of this business for Kass is the recent move toward becoming more entrepreneurial. He says, “Until about a year ago it was a state-owned business. Entrepreneurs bought a controlling stake and have pretty radically changed the management incentives to be equity-compensation-based.” Kass expects management to increase the company's competitiveness by enhancing the brands and products on offer, possibly through M&A activity. He says the company is “likely to have both organic and inorganic growth potential.”

Kass says Yunnan Baiyao is reasonably valued, currently trading around a mid- to high-teens multiple. He believes that given the company is in the earlier stage of maturity, it has a more attractive growth trajectory over the next five to 10 years than many of its multinational peers. Kass recognizes there could be a near-term economic pullback in China, which could adversely impact this stock. But he views this as an exciting long-term opportunity and believes the Chinese are committed to pursuing their China 2025 industrial policy, which should benefit names like Yunnan Baiyao and others in this theme.

Another recent theme is the improvement in traditional Chinese banks with strong deposit franchises, such as **China Construction Bank** (around 1.9% in Emerging Markets and 1.0% in International Growth as of 6/30/2018) and **Industrial and Commercial Bank of China** (1.2% in Emerging Markets as of 6/30/18). Kass says he has observed an “inflection point” in China where market share is shifting away from non-bank

financial institutions to more traditional banks. Several years ago, Chinese authorities started pushing for non-bank credit growth after traditional banks were plagued by poor credit quality. Ultimately, credit growth in the non-bank sector got “out of control,” and more recently the authorities responded by tightening lending within this sector. Kass notes, “After years of being put in a penalty box and being forced to basically keep their balance sheets relatively flat, you had the beginning of the shift in market share in the direction of traditional banks.” At the same time, low-credit-quality industrial companies began to be absorbed into state-owned enterprises that assumed the companies' debt obligations. This resulted in an overall improvement in credit quality that would be beneficial to banks looking to accelerate loan growth.

This is a compelling opportunity for Kass, who says, “We looked at the China banks and saw businesses that had been growing earnings at 2% [but] were positioned to begin to accelerate loan growth. Net interest margins were rising on the margin, but more importantly credit quality was [on the upswing] and non-performing loans [NPLs] were [trending down].” As a result, Kass believes earnings growth could accelerate toward double digits by next year. In addition, the valuation case is persuasive. Kass says these stocks were trading around 0.6x book value and 6x earnings, while paying dividends around 5%. Still, one risk he sees is the new wave of protectionism, which is a threat to the ongoing recovery of credit quality and NPLs within the system. Kass is assessing this risk closely.

### Performance Analysis & Opinion

We have recommended Baron Emerging Markets and Baron International Growth since December 2013.

The performance of both funds since their respective inception dates has been strong.

Over the trailing one-year period, Baron Emerging Markets has outperformed the Vanguard FTSE Emerging Markets ETF by 91 basis points. Over the trailing three-year and five-year periods, Baron Emerging Markets has outperformed by 218 bps and 280 bps, respectively. Baron International Growth has continued to outperform in trailing one-year, three-year, and five-year periods, beating its iShares MSCI ACWI ex U.S. ETF benchmark by 991 bps, 451 bps, and 454 bps, respectively. The recent strong outperformance for International Growth can be attributed in large part to strong stock selection within (and an overweight position in) the information technology sector.

Baron International Growth has gained 12.30% annualized since our start of record for the strategy in January 2009 through June 30, 2018, compared to the 7.49% gain of the iShares MSCI ACWI ex U.S. ETF and 9.06% gain of the MSCI ACWI ex USA Growth Index over the same time period (we use the retail share class prior to the inception of the institutional). Baron Emerging Markets has gained 5.12% annualized since its inception on January 1, 2011. That compares favorably to the 0.77% annualized return of the Vanguard FTSE Emerging Markets ETF.

Both strategies have shown consistency in beating their respective benchmarks over longer periods.

Baron Emerging Markets has outperformed the Vanguard FTSE Emerging Markets ETF in 96% of rolling three-year periods and 98% of rolling five-year periods since inception. And Baron International Growth has outperformed the MSCI ACWI ex USA Index in 100% of rolling three- and five-year periods since its inception.

This strong performance has come with relatively lower risk. Baron Emerging Markets' Sharpe ratio (a measure of the amount of return per unit of risk) since inception is 0.34, notably higher than that of its benchmark (0.07). Baron International Growth's Sharpe ratio since inception is 0.80, higher than that of its benchmark (0.49). The standard deviation for Baron Emerging Markets over the trailing five-year period has been lower than that of its benchmark and peer group. Over the same trailing five-year period, Baron International Growth's standard deviation was roughly comparable to that of its benchmark and peers.

While not yet a concern, we are monitoring the level of assets under management in the Emerging Markets strategy. At around \$6 billion, Kass says he has not had difficulty implementing his investment approach. We have seen the number of holdings grow from around 65 to 93 over the past few years, so dilution of his high-conviction ideas is a risk, and we did raise this issue with Kass. Kass again expressed commitment to soft close at a reasonable level so

Performance Table (6/30/18)										
		Calendar Year Returns					Trailing Returns*			
	YTD	2017	2016	2015	2014	2013	One-Year	Three-Year	Five-Year	Since Start of Rec.
Baron Emerging Markets	-8.59%	40.63%	4.08%	-10.97%	3.75%	15.02%	6.85%	5.86%	7.14%	5.12%
Vanguard FTSE Emerging Markets ETF	-7.32%	31.48%	12.21%	-15.81%	-0.07%	-4.92%	5.94%	3.68%	4.34%	0.77%
Baron International Growth	-0.17%	37.33%	1.35%	1.48%	-2.07%	21.89%	16.27%	9.41%	10.35%	12.30%
iShares MSCI ACWI ex U.S. ETF	-3.95%	27.22%	4.54%	-5.81%	-5.06%	14.74%	6.36%	4.90%	5.81%	7.49%

\*Baron Emerging Markets inception Jan-2011. Baron International Growth start of record Jan-2009. Prior to the fund's May-2009 inception, we use the record of the retail share class.

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.

he can maintain a broad investment opportunity set while maintaining a good liquidity profile. Another mitigating factor is he has more analysts supporting him than when we first recommended his strategy. We continue to monitor the asset level closely.

We believe Baron Emerging Markets and Baron International Growth will beat their benchmarks over the

long term. Our confidence stems from Baron Capital's disciplined long-term approach to growth investing and portfolio manager Kass's superior understanding of long-term themes and business models. We continue to recommend both Baron Emerging Markets and Baron International Growth.

—Alistair Savides, CFA, and Rajat Jain, CFA

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<sup>1</sup> Expense ratios are as follows:

**Baron International Growth Fund:** Annual expense ratio for the Retail Shares and Institutional Shares as of December 31, 2017 was 1.41% and 1.13%, but the net annual expense ratio was 1.20% and 0.95% (restated to reflect management fee reduction from 1.00% to 0.88% and current expense waivers), respectively.

**Baron Emerging Markets Fund:** Expense ratios are as of the fiscal year ended 12/31/2017

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For information pertaining to competitor funds, please refer to that firm's website.

**RISKS:** Non-U.S. investments may involve additional risks to those inherent in U.S. investments, including exchange-rate fluctuations, political or economic instability, the imposition of exchange controls, expropriation, limited disclosure and illiquid markets. This may result in greater share price volatility. Securities of small and medium-sized companies may be thinly traded and more difficult to sell. Even though the Baron International Growth Fund is diversified, it may establish significant positions where the Adviser has the greatest conviction. This could increase volatility of the Fund's returns. 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 Baron Emerging Markets Fund invests in companies of all sizes, including small and medium sized companies.

The discussion of market trends and companies throughout this report are not intended as advice to any person regarding the advisability of investing in any particular security. Some of our comments are based on current 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 of the publication of this report and are subject to change any time based on market and other conditions, and we have no obligation to update them.

MSCI ACWI ex USA Index Net USD measures the equity market performance of large- and mid-cap securities across developed and emerging markets, excluding the U.S. The index performance is not fund performance; one cannot invest directly into an index.

Return of Invested Capital (ROIC) is calculated as Net Income divided by Average Invested Capital multiplied by 100. Average Invested Capital is calculated as the sum of Long-Term Invested Capital including Minority Interest and Total Short-Term Debt. Standard Deviation (Std. Dev) measures the degree to which a fund's performance has varied from its average performance over a particular time period. The greater the standard deviation, the greater a fund's volatility (risk).

There is no guarantee that the Funds' objectives will be met.

Portfolio holdings and sector allocations are subject to change.

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