Reprinted from *Morningstar* magazine
February/March 2017

Expanding Boundaries

Baron Emerging Markets takes the Baron approach to growth investing farther afield.

UNDISCOVERED MANAGER

Tom Lauricella

In every issue, Undiscovered Manager profiles a manager on the Morningstar Manager Prospects list, which is compiled by Morningstar's manager research group.

For Michael Kass, manager of Baron Emerging Markets BEXFX, it's all about finding stocks that will benefit from what he calls Emerging Markets 2.0.

Kass builds his portfolios on a foundation of long-term investment themes. For the six-year-old Emerging Markets fund, the central pillar is that of a secular shift in developing-market economies, away from the kinds of capital-intensive, low-wage manufacturing or state-owned enterprises that have dominated emerging-markets stock portfolios for most of the past three decades.

Instead, Kass is focused on finding entrepreneurial, productivity-driven companies with high return on capital that will benefit from a series of long-term changes across industries and within specific countries. These include companies that stand to benefit from the growing middle class, an emphasis on stepped-up business productivity in the face of rising wages, and regulatory reforms such as the opening up of China's financial sector.

When the fund opened at the end of 2010, "that was right around a major inflection point… that was bigger than anything we would have thought," says Kass. Granted, with this opportunity has come macroeconomic-induced volatility, as soon became evident in 2011. The new fund suffered losses when emerging markets sold off in its first year of operation, and 2015 was rough as well.

However, Kass has navigated these turbulent markets well overall: Baron Emerging Markets gained a cumulative 11.4% from its inception through Dec. 31, as its typical diversified emerging-markets peer lost 14.1% and the MSCI Emerging Markets Index lost 12.7%. The new fund's ability to build positions in 2011's down market may have been an advantage, but its 6.1% annualized five-year return from 2012–2016 ranks among the top 3% of its peers, and its annualized 1.6% loss over the past three years lands in the top quartile.

Venturing Abroad

Featured on Morningstar Prospects, a list of up-and-coming or under-the-radar strategies, Baron Emerging Markets has grown to $2.6 billion in assets. However, Baron Funds is still generally known as a domestic shop.

Ron Baron founded Baron Capital in 1982, and BAMCO, Baron Funds' advisor, in 1987. The $20 billion New York City-based money management firm made a name for itself by identifying fast-growing small and medium-sized companies early in their history. Its calling card is seeking out entrepreneurial managements and companies that can benefit from long-term trends.

Kass, 51 years old, began his investment career in investment banking, but his real interest was money management. He joined brokerage firm Furman Selz in early 1993 and worked as an analyst and portfolio manager on a long-short equity strategy. In late 1996, he began running a long-only growth stock portfolio at Furman Selz Capital Management. When Furman Selz was acquired by ING in 1997, the hedge fund was spun out to a firm that Kass founded, Artemis Investors.

Meanwhile, Kass met Ron Baron regularly over the years. Roy Furman was a close friend of Baron's and Kass knew Baron portfolio manager Cliff Greenberg through hedge fund circles. In late 2007, Baron invited Kass to join the firm to help build out an international stock platform. Although Baron's portfolios held a fair number of non-U.S. stocks, its funds were U.S.-focused at a time when other small- and mid-cap growth managers were expanding into international strategies.

Kass accepted, and spent a year building a team, traveling around the globe, and fleshing out the firm's international investment approach. Baron and Kass believed emerging-markets presented the most intriguing opportunity to apply Baron's investment approach, but thought investors might consider an emerging markets fund a stretch as the firm's first international strategy. That was especially the case as Kass had never run a dedicated international portfolio, although he had experience investing in international stocks at Artemis and Furman Selz.

Instead, they opened Baron International Growth BIGFX at the start of 2009, with Kass at the helm. That fund was designed to be a stepping stone toward the launch of the Emerging Markets fund, and at the start the portfolio held 30% of assets in developing markets, a weighting that has since been upped to 35%. (The typical foreign large-cap growth fund holds less than 15% in emerging markets.) It has outperformed since inception, with a 10.1% annualized return through Dec. 31, vs. 7.9% for its typical category peer. Despite that record, International Growth has less than $100 million in assets; its younger sibling has been the center of attention.

Broadening Horizons

Baron Emerging Markets was slated to open in 2012, but the launch was accelerated to January 2011, as Kass felt that the wind was at their backs.

It was at this point that developing markets were in the final stage of Emerging Markets 1.0, he says. For years, developing markets had benefited from declining inflation and interest rates. Labor cost advantages attracted low-value manufacturing, state-owned enterprises dominated the emerging-markets indexes, and lending was dominated by state-owned banks. "This was the peak of the capital flows coming in, the peak of the Chinese investment cycle and the commodity super-cycle," Kass says.

As the fund was launched, the post-financial crisis, cheap-money party was about to leave a hangover in the form of excess capacity in capital-intensive industries such as commodities. Return on capital rates were plunging.

This was the start of the transition to Emerging Markets 2.0, Kass says. In this new world "there's a deliberate shift of policies and resources to the most efficient agents of the economy. Those tend to be your private-sector entrepreneurs. It's intellectual capital and not blunt investment capital. It's value-added industries."

Against this backdrop, Kass and his team of five dedicated analysts, working in conjunction with the more than two-dozen other sector analysts and portfolio managers at Baron, look to identify actionable themes and companies they believe are best positioned to benefit.

Broadly, they break themes down into industry- and country-specific. Among industry-focused

Michael Kass seeks entrepreneurial companies that will benefit from a secular shift in developing-market economies.

Baron Emerging Markets
BEXFX

Category	**Diversified Emerging Markets**
Expense Ratio (%)	**1.45**
Morningstar Rating	★★★★★
3-Yr Annl Total Rtn (%)	**–1.57**
3-Yr Total Rtn % Rank	**21**

Data as of 12/31/2016

themes, the growth of the consumer and domestic consumption fueled by rising wages is a primary avenue, as it is for many emerging-markets stock-pickers. Kass has been looking at supporting themes, such as mobile e-commerce, and social media. The fund's top holding is China's Alibaba BABA, which it has held since the company went public in late 2014. It also has stakes in Ctrip CTRP and Tencent 00700:HK of China, and Naver 035420:KR, based in Korea.

"When we talk about e-commerce, what it's really about is redirecting a huge revenue pool in a way that's much more capital efficient, stripping out your most capital intensive part—which is your property investment—and dramatically reducing the cost of your salesforce," Kass says.

Productivity enhancement runs throughout Kass' thematic approach, with a focus on companies either specializing in, or benefiting from, robotics and automation. This includes Taiwan-based Delta Electronics 2308:TW, a position added in the second half of 2016. Business productivity software, too, falls under this header. The fund counts among its holdings Brazil's Totvs TOTS3:BR, the largest producer of enterprise solutions in Latin America.

The identification of country-specific themes also drives investment decisions. In India, for example, the country's goods and services tax overhaul in 2016, which was part of a broader economic reform effort, should be a big boost for conglomerate Amara Raja Batteries AMARAJABAT:IN.

In China, a major area of emphasis is on financial reform. Historically, finance in China revolved around the state-owned banks, but that is changing.

"A few years ago, 90% of all capital allocation went through traditional banks, while the securities industry, the bond markets, securitization etc. was 10%," Kass says. "Securitization is now 15% and we think it's going toward 40% in five to 10 years. That means that the earnings power of the Chinese securities industry will grow multiple-fold." In addition, Kass believes financial reform, which includes a developing corporate and municipal bond market, will lead to a rise in professional asset management for Chinese investors.

Kass' preferred play on this theme has been Haitong Securities 06837:HK, which has investment banking, brokerage, trading, and asset management businesses. Despite his conviction in the long-term potential of this trend, Kass had a relatively small weighting for Haitong at 1.3% as of December. (At the end of 2014, the position was north of 3%.) The reason: He's more concerned about the potential for a credit crisis in China. "I'd rather get aggressive once we know what we're looking at," he says.

Checking Risk

As part of Kass' risk management tool kit, he keeps a close eye on macroeconomic and liquidity indicators among individual markets. However, he says, "we're not making predictions about what the macro environment is going to do; it's about what is priced into the market. It's about looking for opportunities in this particular country or this particular sector vs. reducing your exposure there. And I don't mean on a short-term basis; it's on a strategic basis—for the next couple of years."

In the third quarter of 2015, for example, Kass was underweighting Brazilian stocks with just 3.4% allotted to the country, roughly half the weighting of the MSCI Emerging Markets Index. The portfolio doesn't hedge its foreign currency exposure, but Kass keeps an eye on currency markets as a reflection of investor sentiment. At the time, he watched as the cost to hedge exposure to the Brazilian currency surged to levels comparable to the extremes seen on currencies during the eurozone crisis. That was a signal that it was time to start building positions back up.

Among the moves he made in the fourth quarter of 2015 in Brazil was to re-establish a position in BM&F Bovespa BVMF3:BR. The company has a near monopoly in running equity and commodity exchanges in Brazil, and Kass believes it will benefit from long-term securitization themes.

When doing the bottom-up work on stocks, Kass says the goal is to find shares that can double in value over a five-year time horizon, or provide a 15% compounded annual growth rate.

When it comes to selling a stock, those decisions tend to be driven by changing underlying fundamentals, such as data suggesting an investment thesis is no longer valid, or management changes. Valuations also come into play. As the team believed valuations were stretched and growth prospects were deteriorating, the fund sold two of its generic pharmaceutical companies in 2015: Lupin LUPIN:IN, first bought in March 2011, and Glenmark Pharmaceuticals GLENMARK:IN, first added in November 2014.

The fund's risk profile is a testament to the approach so far. Over the past five years, it has captured 86% of the upside of the MSCI Emerging Markets Index but suffered only 62% of its losses. Its relatively modest 11% loss in 2015 put it in the top third of the category. That may have owed partly to an above-average cash stake—the fund saw considerable inflows that year—but there is reason to expect continued moderate volatility given the strategy: Baron's domestic-equity funds are generally less volatile than their peers.

Of course, any emerging-markets investment requires a long-term horizon. That's the approach Kass takes. He says, "On a secular basis—for the next 10 or 15 years—there's something happening in emerging markets that gives us a big tail wind." M

Tom Lauricella is the editor of Morningstar Direct.

Baron Emerging Markets Fund has been categorized in Morningstar's US Fund Diversified Emerging Mkts Category since inception.

Baron Emerging Markets Fund's inception date was December 31, 2010

The Baron Emerging Markets Fund Retail Share Class is in the Morningstar US Fund Diversified Emerging Mkts. As of 12/31/16, the category consisted of 813 and 606 funds for the 1-year and 3-year time periods. Baron Emerging Markets Fund ranked in the 77th percentile for the 1-year time period and in the 21st percentile for the 3-year time period ended 12/31/2016.

The Baron Emerging Markets Fund Institutional Share Class is in the Morningstar US Fund Diversified Emerging Mkts. As of 12/31/16, the category consisted of 813 and 606 funds for the 1-year and 3-year time periods. Baron Emerging Markets Fund ranked in the 75th percentile for the 1-year time period and in the 17th percentile for the 3-year time period ended 12/31/2016.

Specific risks associated with investing in smaller companies include that the securities may be thinly traded and more difficult to sell during market downturns. Even though the Fund is diversified, it may establish significant positions where the Adviser has the greatest conviction. This could increase volatility of the Fund's returns.

You should consider the investment objectives, risks, charges, and expenses of any of the Baron Funds carefully before investing. The prospectus and summary prospectus contain this and other information about Baron Funds. You may obtain them from their distributor, Baron Capital, Inc., by calling 1-800-99BARON or click here. Please read them carefully before investing.

Baron Emerging Markets Fund's annualized returns for the Retail Shares as of December 31, 2016: 1-year, 3.75%; 5-years, 6.11%; Since Inception (12/31/2010), 1.82%. Annual operating expense ratio for the Retail Shares as of December 31, 2015 was 1.45%.

Baron Emerging Markets Fund's annualized returns for the Institutional Shares as of December 31, 2016: 1-year, 4.08%; 5-years, 6.38%; Since Inception (12/31/2010), 2.07%. Annual operating expense ratio for the Retail Shares as of December 31, 2015 was 1.20%.

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 or call 1-800-99BARON.

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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 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 Fund may not achieve its objectives. Current and future portfolio holdings are subject to risk.

Portfolio holdings as a percentage of net assets as of December 31, 2016 for securities mentioned are as follows: **Alibaba Group Holding Limited** – 3.5%; **Ctrip.com International, Ltd.** – 1.3%; **Tencent Holdings, Ltd.**– 2.3%; **Naver Corporation** –1.6%; **Delta Electronics, Inc.**–1.3%; **TOTVS SA** –0.8%; **Haitong Securities Co., Ltd.** –1.3; **BM&FBOVESPA SA**–1.5%

Portfolio holdings may change over time.

Corrections:

Lupin Limited and Glenmark Pharmaceuticals were added in 2015, not sold.

The discussions of the companies herein are not intended as advice to any person regarding the advisability of investing in any particular security. The views expressed in this report reflect those of the respective portfolio manager only through the end of the period stated in this report. The portfolio manager's views are not intended as recommendations or investment advice to any person reading this report and are subject to change at any time based on market and other conditions and Baron has no obligation to update them.